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REAL ESTATE OUTLOOK

November
December 1987

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The total output of goods and services, after adjusting for inflation, increased at an annual rate of 3.8 percent in the third quarter. Consumption spending and business fixed investment were the strongest sectors in the economy in that quarter.
- The stock market crash is expected to reduce consumer spending over the next few quarters. Solid growth in net exports due to large gains in U.S. exports will replace consumption spending as the strongest contributor to fourth quarter real GNP growth.
- Fears of high inflation are said to have been a possible cause of the stock market crash. These fears appear to have dissipated and consumer prices are expected to increase by only 4.3 percent in the current quarter, and 4.1 percent in 1988.
- The bond market rally has pushed down yields on long term U.S. Treasury securities by as much as 150 basis points. Mortgage rates are expected to follow suit, trending down throughout 1988.
- Sales of existing single-family homes could reach 3.21 million units in 1988, 3 percent below the projected 1987 rate of 3.32 million units. This expected decline is partly due to losses of wealth from the stock market crash which will be offset by declines in mortgage interest rates.

IN THIS ISSUE

- **Economic Commentary: AN ILL WIND, by John A. Tuccillo**
- **Outlook for the Economy & Real Estate**
- **Secondary Market Outlook, by Mary A. Fruscello**
- **Special Topic: The Homebuying and Selling Process, 1987**

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Forecasting & Policy Analysis Division
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AN ILL WIND:
Economic Commentary

by
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It is an ill wind that blows no good, but the stock market debacle of the past several weeks emphatically does not qualify. Although we've seen a great deal of wealth wiped out, the shift of funds from stocks to bonds – a full-blown flight to liquidity and quality – will push interest rates down through the end of 1987 and revive what had become a disturbingly sluggish housing market. But like the mild heart attack sent as a warning by nature, the market drop is signaling some deeper sickness within the economy that needs to be cured if the patient is to live a long healthy life.

By now, we've all read about the ins and outs of the big Crash of '87: how nearly $1 trillion in wealth was wiped out; how investment firms became completely overwhelmed by orders; how most of middle America was, at least initially, unaffected; how a yuppie stockbroker differs from a pigeon in that the pigeon can still make a deposit on a BMW. But look at this from the point of view of real estate. The losses in the stock market triggered a bond market rally that has pushed both long- and short-term rates down. Adding to this has been the actions of the Federal Reserve in flooding the economy with cash in an effort to avert the catastrophes of 1929. As a result, long-term Treasuries fell by about 125 basis points in a ten-day period, federal funds are trading a full point below their September highs and mortgage rates are headed south.

This will be good for housing for two reasons. First, lower interest rates, especially in a growing economy, will necessarily stimulate home sales and construction. But, also, mortgage rates have been trending upward since March, with a particular burst in September. The break in that progression that we are now witnessing will unleash the demand that had been stifled all summer. We ought to see a fourth quarter of greater-than-expected housing activity.

But how can housing thrive while wealth is being destroyed? Clearly the stock market plunge destroyed the capability of many households to buy a house and crippled the confidence of others. I don't believe that this is a problem, at least in the short run. In fact, relatively few Americans were caught under the falling Dow. On a year-to- year basis, the DJIA is virtually unchanged from October 1986. Moreover, many losses took the form of declines in the value of their pension funds, a factor which enters only weakly into current consumption choices. Should the market disaster permeate the economy and generate a recession, housing will suffer in the first half of 1988. For now, consumer confidence appears to be holding, and interest rates will dominate housing for the remainder of 1987. The prospects for 1988 will become clearer as the stock market sorts itself out. Those prospects will hinge on whether policy makers in Washington and the rest of the world heard the message of Wall Street. There are some very real problems with the American economy, and those who predict the future by playing the stock market have clearly expressed their doubts that the current expansion can survive those problems. Right now, our current account deficit is equal to 3.6 percent of GNP. The world will eventually force us to zero-out that balance; either we will produce more and consume less, or the international markets will drive the value of the dollar steadily lower.

On the domestic side, our Federal budget deficit is still out of control. Even though the fiscal year 1987 deficit fell to $148 billion, there has been no real movement to close the gap fully. The longer the deficit persists, the greater are the chances that interest rates will remain high to attract foreign capital. Wall Street knows, and has clearly stated, that the perpetuation of the two deficits cannot exist simultaneously with a consumption-based economic expansion. Simply put, our spending spree has been financed by foreign funds, and the IOUs are coming due.

Without real solutions, the day of reckoning will inexorably approach. Soon there will be no options except for a period of higher taxes and lower real consumption. But like Scrooge on Christmas Eve, we have seen what might be and still have time to change. The dollar will likely fall by another 10 percent against major currencies before year-end. If that is accompanied by a real reduction of the federal deficit by the President and the Congress of $40-50 billion, then the markets will calm and the basic strength of the economy will reassert itself. But that deficit reduction must occur as part of a longer range program of fiscal discipline if it is to convince financial markets that the future is bright.

A former chairman of the Fed characterized his role as the guy who takes away the punchbowl just when the party's getting good. Well, the party's not yet over, but we need to take away the punchbowl and bring out the coffee urn.

Outlook for the Economy and Real Estate

Now that the bull has stopped charging, economic growth will be slower and its composition much different from the surprisingly strong third quarter real GNP annual growth rate of 3.8 percent. The third quarter reading on the health of the U.S. economy painted an image of a renewed level of real growth drawing from large gains in exports, stronger consumer spending, and greater business fixed investment. Compared to the 3.4 percent annual growth rate of the first half of 1987, the economy might have been positioning itself for another growth surge.

September seemed to be a good month for economic indicators: personal income advanced 0.7 percent, nondefense durable goods orders jumped 1.7 percent and inflation (as measured by the GNP deflator) increased at only a 2.4 percent annual rate during the third quarter, compared to 3.5 percent in the second.

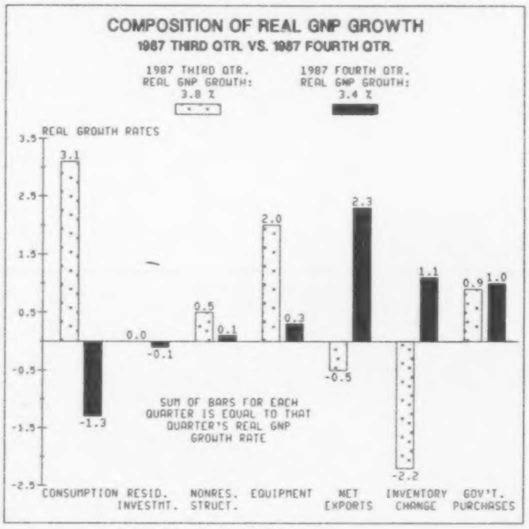
Changing Composition of Real GNP Growth

As always, numbers play tricks on the eyes and ears of economists. For example, the 16.5 percent annual rate of growth in the third quarter volume of U.S. exports was actually offset by an equal percentage rise in import volume. And since import volume is approximately one-third larger than export volume, the equal percentage rise in imports actually pried open the trade gap a bit further. Responding to tensions in the Persian Gulf, a huge petroleum inflow of $19.3 billion explained most of the import rise but not all. Nonpetroleum imports continued to increase in the third quarter, as America's appetite for foreign goods lingers on despite rises in import prices. The result was a negative contribution from net exports to real GNP growth (see Graph). Despite this setback in net exports, trade is expected to resume its positive contribution to GNP growth in the fourth quarter and into 1988, helping to offset the expected widespread weakness in other sectors. Next year could be remembered as the year in which the trade gap fell, if the effect of the stock market crash on current spending is enough to dissuade consumers from the more expensive imported goods and in favor of U.S. products.

Consumer spending has been all but ruled out as a source of economic growth in the current quarter. The stock market crash is expected to be the straw that breaks the debt-laden consumer's back and could force a return to a more normal rate of personal savings. The fat 4.8 percent rise in consumer spending during the third quarter borrowed from this quarter's auto sales, setting up yet another payback period for the auto industry. Further, the 0.7 percent September gain in personal income masks the fact that consumer incomes adjusted for inflation are virtually unchanged over the past year. Coming only weeks before the beginning of the retail industry's make or break quarter, the effect of the stock market crash will be felt immediately.

So, while the economy had been gaining on the basis of export growth, consumer spending and business fixed investment, the latter two are not as likely to contribute positively to real GNP growth in the next few post-crash quarters.

Two responses in consumer spending to the stock market crash are expected. First, the loss of $1 trillion in wealth will have a direct effect on the 20 percent of consumers who were actively investing in the stock market. Many of these consumers are on the high end of the income scale and account for a larger share of consumption than their small share of the population might suggest. It is important to keep in mind that that the loss of $1 trillion in wealth only represented wealth earned since about the beginning of 1987, and not since the 1982 start of the bull market.



The indirect effect centers around how consumers not in the stock market will react. Consumer confidence at present seems to be holding steady. The fact that the homeownership rate in the third quarter of 1987 was 64.0 percent compared to the 47.8 percent rate of 1930 suggests that the total distribution of personal wealth is skewed more toward real estate than it was during the Great Depression. This greater proportion of assets in real estate is complemented by a far more secure financial system backed up by extensive deposit insurance programs. These two factors in particular are keys to understanding the steadiness of consumer confidence.

Net exports are expected to provide the steadiest source of real GNP growth in the current quarter, producing an annual rate of about 3.4 percent. After a sluggish first half in 1988, real GNP growth could rebound in the second half on the strength of buoyant consumer spending. This could bring the average annual rate of real GNP growth to 2.4 percent next year. As with the other sectors, it is too soon to tell if capital spending plans of businesses have been revised down across all sectors. Unofficial indicators and surveys suggest that business executives for the most part feel confident that consumers will not overreact to the stock market downturn by immediately postponing all spending.

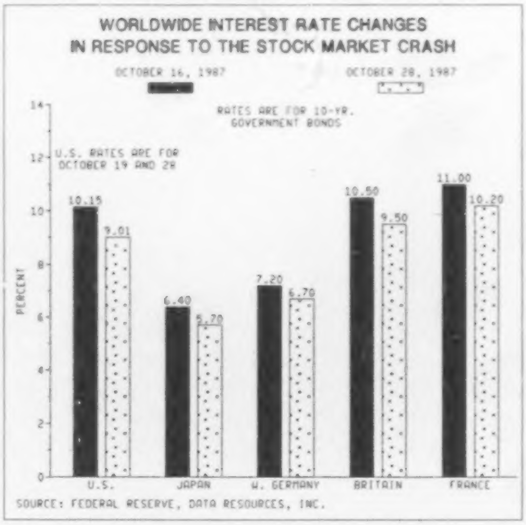
These developments generally portend good news for consumer price inflation in 1988. The CPI is expected to increase by 4.1 percent in 1988, a downward revision from the last forecast. A broader estimation of inflation, the GNP price deflator, is expected to rise by 3.1 percent in 1988, also revised down from the previous forecast. A slower rate of growth in total output forced by the expected weakness in consumption explains most of the lower rate of inflation. The lackluster output growth could nudge the employment rate up over 6 percent in 1988. Nevertheless, modest wage gains are expected in 1988 after many quarters of little or no change.

Monetary Policy and Interest Rates

As the Dow Jones Industrial Average plummeted, so too fell the high inflationary expectations of financial market participants. This has granted Chairman Greenspan greater leeway in conducting a monetary policy conducive to stable economic growth. In fact, the Fed's quick move to increase liquidity was just the assurance many investors needed. This has helped satisfy the tremendous demand for cash and has led many major banks to announce hefty reductions in the prime rate.

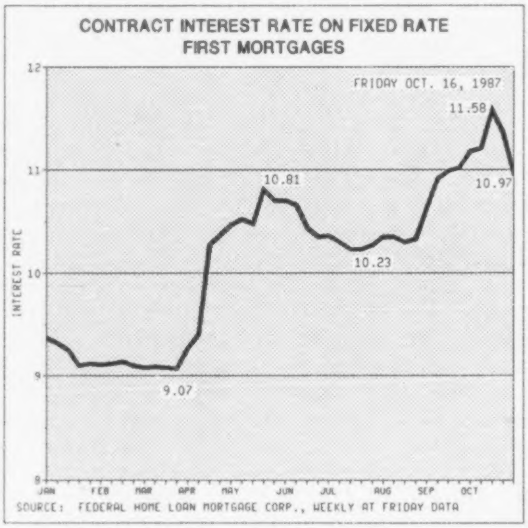
But at the same time, the Chairman must also pursue a monetary policy which keeps the spread between the interest rates on dollar denominated assets and those on comparable foreign investments wide enough to keep large amounts of foreign capital flowing into the domestic economy. (see Graph) Currently, world interest rates are dropping together because of the stock market crash. These rate differentials must be maintained, particularly to continue to attract capital from Japanese investors.

The conduct of monetary policy with respect to these foreign capital inflows is particularly important to avoiding a recession. The Administration and Congress are working out a budget compromise that will reduce the share of economic growth due to spending by the Federal Government. This contractionary fiscal policy will have to be offset by a more expansionary monetary policy that encourages world interest rates to decline and domestic investment and private spending to increase.


WORLDWIDE INTEREST RATE CHANGES IN RESPONSE TO THE STOCK MARKET CRASH

SOURCE: FEDERAL RESERVE, DATA RESOURCES, INC.

This policy shift from anti-inflation to anti-recession carries good news for the housing industry in the form of lower interest rates. Already the flight to quality (from stock into bonds) has touched off a bond market rally that has driven yields on long-term Treasury securities down by 150 basis points. The rate on a 30-year fixed rate mortgage could drop to 10.6 percent in the current quarter before seesawing throughout 1988 to an annual average of 10.8 percent.


CONTRACT INTEREST RATE ON FIXED RATE FIRST MORTGAGES

SOURCE: FEDERAL HOME LOAN MORTGAGE CORP., WEEKLY AT FRIDAY DATA

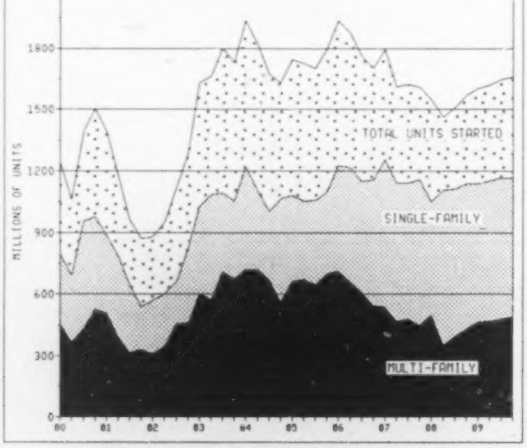
Real Estate Markets

Housing Starts

Total housing starts in September reached an annual rate of 1.669 million units, up 4.4 percent from the revised August annual rate of 1.598 million units. The September 1987 rate was 1.2 percent short of the September 1986 rate of 1.689 million units.

September single-family units were started at an annual rate of 1.168 million units, 5.1 percent above the revised August annual rate of 1.111 million units. The September 1987 single-family start rate was 4.0 percent below the September 1986 rate. Higher interest rates continued to hold down single-family starts activity. Single-family starts are forecast to reach an average annual rate of 1.158 million unit rate in the fourth quarter of 1987. Single-family starts could fall to a 1.102 million unit average annual rate in 1988.

HOUSING UNITS STARTED
TOTAL, SINGLE- AND MULTI-FAMILY

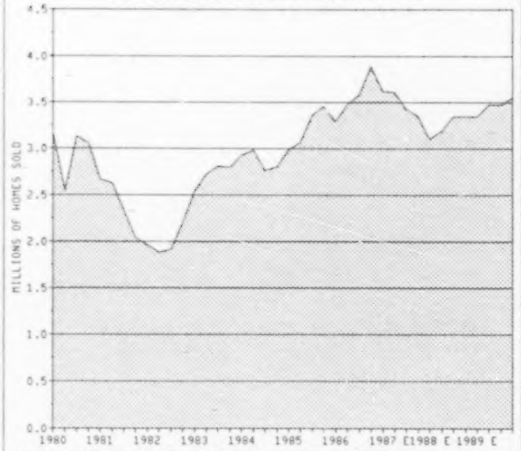


Multi-family housing units were started at an annual rate of 501 thousand units in September, a 2.9 percent gain over the August annual rate of 487 thousand units. The annual rate of multi- family starts was 11.5 percent below the September 1986 start rate. Multi-family units are expected to be started at an average annual rate of 451 thousand units in the current quarter, before slowing to an average annual rate of 420 thousand units in 1988.

Existing Home Sales

Existing single-family homes were sold at a seasonally adjusted annual rate of 3.45 million units in September, up 1.2 percent from the revised August rate of 3.41 million units. Seasonally adjusted existing single-family home sales rates rose in all regions of the country with the exception of the West region. In that region, the existing home sales rate declined 5 percent from the August rate of 600,000 units to the September rate of 570,000 units. The Northeast annual rate rose from 670,000 units in August to 690,000 units in September, a 3 percent increase. Existing homes in the Midwest region were sold at an annual rate of 880,000 units, up 2.3 percent from the August annual rate of 860,000 units. In the South, existing home sales reached an annual rate of 1.31 million units, also a 2.3 percent rise above the August rate of 1.28 million units.

EXISTING SINGLE-FAMILY HOME SALES



SOURCE: HISTORY FROM NAR ECONOMICS & RESEARCH. E FROM NAR FORECASTING & POLICY ANALYSIS.

The forecast for total existing single-family home sales has been revised down from the September/October REO forecast of 3.32 million units for 1988, to 3.21 million units, a 3.6 percent decline. Most of this strength in existing home sales derives from mortgage rate declines and the assumption of no prolonged and serious decline in consumer confidence. Existing single-family home sales are expected to fall somewhat because of the stock market crash. The extent of the reduction will be tempered by the expected decline in lower mortgage rates brought about by a bond market rally. The strong demand for fixed-income investments like bonds has driven their prices up and their yields down. [For further information, read "Secondary Market Outlook" in this issue.]

The median sales price of an existing single-family home sold in September fell slightly to $84,900, a 0.2 percent decline from the $85,100 August median sales price for an existing home. This small decline is more than likely a seasonal decline that is characteristic of this not seasonally adjusted price data. In 1987, the median sales price is expected to average $84,600, a 5.4 percent rise over the $80,300 median sales price of 1986. Factoring in the expected 3.7 percent annual rate of inflation for 1987 (year-over-year percent change) means that existing home prices will on average experience a real increase of almost 2 percent.

New Home Sales

Some of the relative strength in existing home sales is due to reduced activity in the new home sales market. Sales of new single-family homes are expected to fall to 630 thousand units in 1988 before recovering somewhat to 670 thousand units in 1989. With most of the data on 1987 already reported, it appears that new home sales will total 681 thousand units in 1987, down 0.3 percent from 1986.

The median sales price of a new home sold in September rose to $115,600, an 8.5 percent increase over the August median price of $106,500. New homes have continued to rise in price despite declines in new home sales volume. New homebuyers remaining in the market after the rises in mortgage interest rates during the Spring and early Fall are likely to be higher-income homebuyers who typically buy the more expensive new homes. New home prices could rise by 4.3 percent in 1988 to $109,900, as this trend continues.

RISKS TO THE FORECAST

In the previous forecast, the interplay of the value of the dollar, the rate of inflation and the attractiveness of U.S. real interest rates to foreign investors was given as a potential threat to the housing estimates made therein. That caution applies to this forecast as well. However, the stock market crash has increased the pressure on monetary authorities around the world to minimize the uncertainty engendered by the complex relationship of the dollar, inflation and real interest rates.

Another critical viewpoint to take when evaluating this forecast is to consider that consumer spending could take longer to recover than the third quarter of 1988, as assumed. If it does, then the likelihood of a recession in late 1988 is slightly higher, but by no means is it a certainty.

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Secondary Market Outlook

by
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A dramatic illustration of the advantages and disadvantages of the close link between the mortgage and capital markets, and the dependency of home buyers and sellers on stability in the mortgage securities markets, occurred with the stock market debacle in October. As the equity markets plunged, investors began a classic "flight to quality," abandoning stocks for Treasury notes and bonds. The immediate effect on the mortgage backed securities market was a price decline, followed quickly by investor realization that for most pass-through securities, the quality of the guarantee is the same or substantially the same as that for Treasuries. As a result, mortgage backed securities have participated in the rally in bond prices, producing lower yields to investors.

At the same time, however, the highly touted liquidity of the mortgage backed securities market took its second hit since April. Most major investment banking houses stopped making bids for securities at some point during the week of Black Monday, and in the following week traders remained reluctant to position in securities, preferring to take sell orders subject to their finding buyers.

For housing and homebuyers, the effects of these conditions are likely to be mixed. Investor preference for bonds, including mortgage backed securities, as well as the Fed's less restrictive monetary policy, can translate into lower mortgage interest rates. Many mortgage lenders, however, are faced with an unpleasant reality in this scenario. Those who have purchased forward commitments to sell mortgages in the securities market are likely to be faced with borrowers who walk away from commitments at rates now above market, forcing lenders to take losses from their mandatory delivery securities sales positions. Unfortunately, rising rates had already reduced volume, making the decline less welcome than might have been expected. There is also some indication that continued erratic liquidity in the mortgage securities market may be due to anticipation of supply problems stemming from a slowdown in origination volume as consumers look for reassurance about the economy before buying homes.

The liquidity problems in the fixed rate securities market come at a time when problems with ARMs and ARM securities are beginning to surface. As mortgage rates began moving up this year, borrowers predictably demonstrated a decided preference for adjustable rate mortgages. Since early spring, ARM popularity as reported in the National Association of Realtors Survey of Home Financing Transactions grew from 7 per cent of first mortgage originations in April to 33 per cent in September.

The move from fixed rate to adjustable rates loans has been relatively smooth, with no financing gaps while lenders developed an alternative product. However, there have been two disturbing aspects to the rapid shift to ARMs: the limited progress towards standardization of loan terms, and the disappointing reception by the investment community for ARM mortgage backed securities.

When ARMs became nationally popular during the high rate period of the early eighties, there were no FHA, Freddie Mac or Fannie Mae ARM programs. Left to the forces of an unstructured and competitive marketplace, lenders created a plethora of loan terms, indices and pricing structures in their scramble to lure borrowers into a financing technique that would allow them to qualify for loans during that period of unprecedented high interest rates. Since those heady days of highly creative mortgage lending, the conventional wisdom has been that lenders are now sensitive to the pitfalls of a fragmented mortgage market and an illiquid product line.

Yet the picture of ARM lending since mortgage interest rates began their upward march in late spring is not encouraging. True, there has been some standardization of basic ARM terms, such as index, adjustment period and amortization rates. The Home Financing Transactions Survey indicates that the market has largely settled on two ARM indices--U.S. Treasury constant maturity and the FHLBB cost of funds--adjustment periods of one or three years, and no negative amortization. But in the rush to offset declining loan volume as refinance activity abated, many portfolio lenders began originating ARM product at below market prices, and the market began to return to the chaos of 1982-83.

Teaser rates--initial interest rates well below the fully indexed level mandated by the ARM index rate and margin--are again widely reported, creating several potential problems. Portfolio lenders are using discount pricing to trade current yield for the interest rate sensitivity of ARMs. They are offsetting their losses by using an accounting method that (until the end of 1987) permits full recognition of point income when the loan is booked. Unfortunately, the teaser rate strategy in some cases produces loans that may take many years, if ever, to reach market rates of return.

If borrowers retain their new found preference for ARMs, the effect of such price cutting will be felt in the mortgage market much more quickly. Mortgage bankers are finding themselves unable to compete with the ARM teaser rates, because the prices they receive for such loans in the secondary market are not adequate to produce a break-even spread on the loan sale. For borrowers, this could produce a short-lived windfall in mortgage terms, followed by a financing scarcity as some mortgage sources disappear.

Even more disturbing than the problems in the ARM origination market, however, is the lukewarm reception by investors to the ARM securities that have been introduced. The GNMA ARM has had only modest volume, in part because of the arbitrary limitations that until recently have been placed on FHA ARM commitments available to lenders, restricting origination volume to unmarketable levels. Even the more recent Freddie Mac ARM security is not highly visible in the trading markets.

Market observers attribute some of the investment reluctance to the lack of volume outstanding. There have been only $4 billion Freddie Mac ARMs issued, and only $2.6 billion in GNMA ARMs. Many of these securities, once issued, do not trade, an indication that, unlike the fixed rate security, the ARM security investor base is narrow and not substantially different from that of the ARM mortgage itself. Without an active resale market, ARM securities cannot offer the liquidity that attracts buyers.

An even greater concern, however, is the lack of analytical tools to value ARM securities. Pricing models vary as widely as they did three years ago; they are complex and (in some cases) highly arbitrary. Investors, lacking confidence in the pricing approaches available, have not rushed to these new products.

Also contributing to the spotty liquidity in ARM security trading is the lack of an effective hedging vehicle. With no instrument to offset risk, traders are reluctant to position in ARM securities, hindering the development of an active trading market.

The disappointing progress in ARM standardization reflects the highly cyclical nature of the product. When rates are low, minimal borrower and investor interest in ARMs discourages attention to the limitations of this new and somewhat untested product. A protracted interest rate rise may provide enough time for the market to focus on solving critical problems such as pricing techniques to facilitate trading and liquidity.

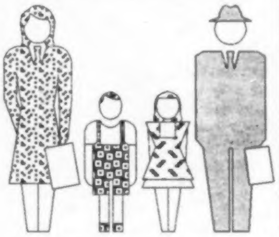
For the present, however, investors are unable to evaluate ARMs with techniques conducive to rapid trades. The result is that the primary ARM market is not being driven by secondary market needs, and as we have learned in the past few years, secondary market requirements must become the focus if we are to have efficient markets and a steady supply of affordable funds to borrowers. From that perspective, and given the disruption in liquidity for fixed rate mortgage securities, continued volatility in the capital markets may prove a mixed blessing for housing and homebuyers, as it deprives mortgages of the liquidity essential to make reasonably priced financing available.

SPECIAL TOPIC:

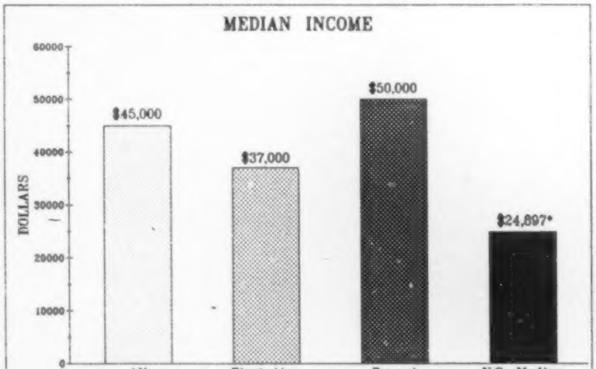
THE HOMEBUYING AND SELLING PROCESS: 1987

A recently published report titled The Homebuying and Selling Process: 1987 (NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division), provides a nationwide profile of the homebuyer, the home purchase process, the homeselling process, and a close look at 12 metropolitan housing markets. The report is based on a sample of nearly 4,000 homebuyers who purchased homes during the last six months of 1986.

The typical homebuyer in 1986 was a 35-year-old married couple with dependents. Together they had a combined income of $45,000.



While it is interesting to take a snapshot look at the typical homebuyer of 1986, a closer look reveals a great deal of variation in the homebuying public.



*Source: Census Bureau

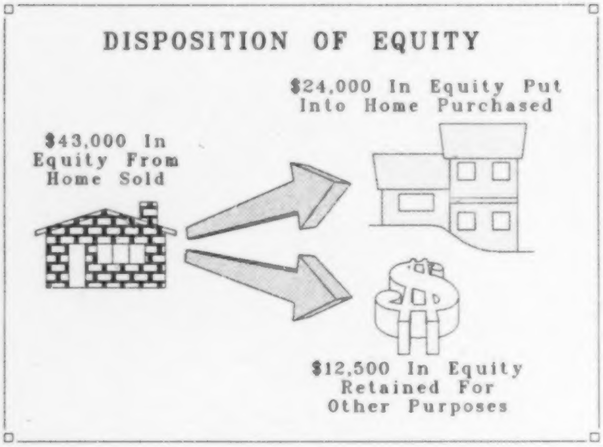
As would be expected, first- time buyers are, on average, about 10 years younger than repeat buyers. Two-thirds of first-time buyers are in the prime homebuying years between the ages of 25 and 34 compared to only 30 percent of repeat buyers. Over one-third of repeat buyers are in the 35 to 44 year old age group where one finds the heaviest concentration of families with higher incomes and an increased need for space. The median age of all homebuyers is 35.

The income data demonstrates why housing affordability is such a vital social issue in the United States today. Ninety percent of first-time buyers earned more than the national median household income ($24,897) in 1986. The median income of first-time buyers was $37,000 – over $12,000 more than the national median household income. The income data for repeat buyers is equally striking: the median income of repeat buyers is approximately twice the median income of all households, and most repeat buyers earned more than the median income of all households. This is remarkable since it occurred at a time when the Housing Affordability Index, a widely used measure of housing affordability, was well over 100 and had been improving for over six years.

Seventy-one percent of all homebuyers surveyed were repeat buyers. Compared to first-time buyers, they are generally older, have higher incomes, and buy more expensive homes. But there are other findings concerning repeat buyer purchasing behavior that may be of interest.

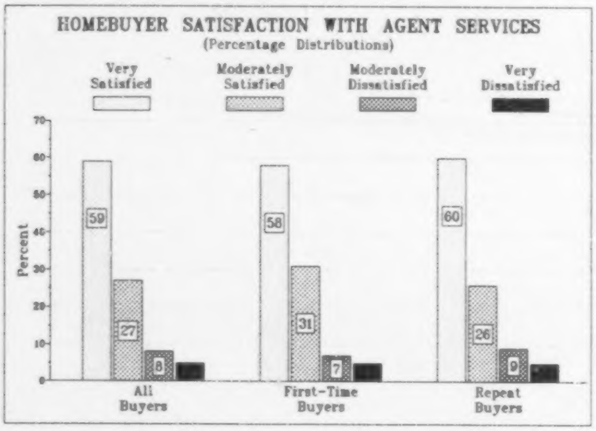
Sixty-four percent of repeat homebuyers in the survey sample were trading up – buying a home worth at least 10 percent more than the home they sold. The median home price paid by trade-up buyers was $115,000, an increase of $39,500 over the home they sold. Seventeen percent of repeat buyers bought homes in the same price class as the home they sold and 19 percent were trading down – buying a home worth at least 10 percent less than the home they sold. The difference in the median price between the homes trade-down buyers purchased and the homes they sold is remarkable: $63,000. Data on trade-down buyers is influenced by older buyers who often sell large detached single-family homes and purchase either small detached single-family homes, townhomes, or apartment condominiums. In fact, 30 percent of buyers age 55 to 64 and 32 percent of buyers age 65 and over claimed their preference for a smaller home was a major reason for moving.

This aspect of trading patterns raises the question of the disposition of equity. Equity from a previous home was cited most frequently by repeat buyers as


DISPOSITION OF EQUITY
$43,000 In Equity From Home Sold
$24,000 In Equity Put Into Home Purchased
$12,500 In Equity Retained For Other Purposes

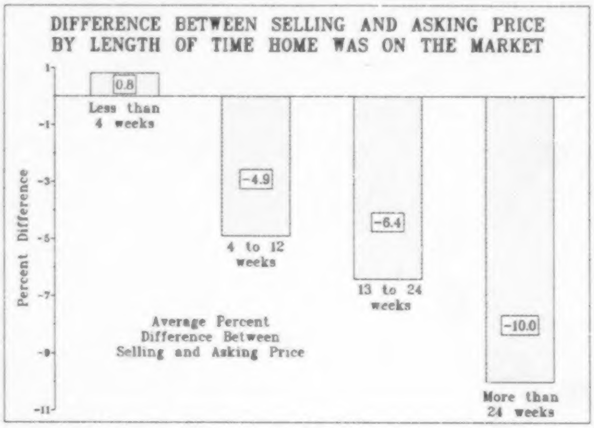
a source of downpayment on another home. The median amount of equity put into a home purchase by repeat buyers, however, was significantly less: $24,000. The difference is equity retained for other purposes; for example, closing costs on the property purchase, relocation expenses, making ancillary purchases, home improvements, or investments.

One aspect of the homebuying process that is critically important to real estate professionals is the level of homebuyer satisfaction with the services provided by real estate agents. The survey results indicate that 86 percent of the homebuyers were satisfied with the services provided by their real estate agents. In fact, 59 percent indicated they were very satisfied. Nearly three-quarters of the survey panelists claimed they would be willing to use their agent again if the opportunity presented itself while only one respondent in 10 said he would not.



As noted above, 71 percent of the national survey panelists were repeat buyers. These experienced homebuyers represent a primary source of information about the homeselling process. One aspect of this process that may interest Outlook readers concerns the difference between the selling and asking price of homes.

The basic forces of supply and demand are evident in survey results that compare the average percent difference between the actual selling prices of homes and the asking prices. On average, homes that were on the market for less than four weeks actually sold for slightly more than the original asking price. However, as the length of time a home was on the market increased, so did the difference between the asking price and the selling price. Homes on the market for more than 24 weeks sold for an average 10 percent less than the asking price.



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November/December 1987

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1985.0	1986.0	1987.0	1988.0	1989.0
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4445.1	4512.0	4576.2	4627.6	4680.7	4758.4	4840.2	4937.2	4010.3	4235.0	4477.8	4726.7	5070.0
% Change	6.3	6.2	5.8	4.6	4.7	6.8	7.1	8.3	6.3	5.6	5.7	5.6	7.3
% Change (w/out inflation)	2.5	3.8	3.4	1.5	1.0	2.9	3.3	3.8	3.0	2.9	2.8	2.4	3.0
Consumer Prices (CPI)	4.9	3.9	4.3	3.9	3.8	4.1	4.4	4.9	3.6	1.9	3.7	4.1	4.6
GNP Deflator	3.5	2.4	2.2	3.1	3.6	3.8	3.6	4.3	3.2	2.6	2.9	3.1	4.1
Unemployment Rate (%) (civilian)	6.2	6.0	6.0	6.0	6.2	6.2	6.2	6.0	7.2	7.0	6.2	6.1	5.9
Civilian Employment-Household Basis (millions)	112.2	112.9	113.4	113.8	114.1	114.4	114.9	115.5	107.2	109.6	112.4	114.3	116.2
% Change	3.4	2.4	1.8	1.6	0.9	1.3	1.6	2.1	2.0	2.3	2.6	1.7	1.7
Mfg. Capacity Utilization	80.5	81.5	82.0	82.4	81.9	82.1	82.4	82.9	80.3	79.7	81.0	82.2	82.9
Domestic Auto Sales	7.0	8.0	6.1	6.7	7.2	7.2	7.5	7.4	8.2	8.2	7.0	7.1	7.4
Federal Tax Receipts (NIPA) as % of GNP	0.21	0.20	0.20	0.20	0.20	0.20	0.20	0.21	0.20	0.20	0.20	0.20	0.21
Federal Expenditures (NIPA) as % of GNP	0.24	0.24	0.24	0.24	0.24	0.23	0.23	0.23	0.25	0.24	0.24	0.24	0.23
Deficit(NIPA)	-139.2	-148.9	-187.2	-168.9	-156.9	-162.1	-155.0	-128.0	-196.0	-204.7	-161.5	-160.7	-122.6
as a % of GNP	-3.1	-3.3	-4.1	-3.6	-3.4	-3.4	-3.2	-2.6	-4.9	-4.8	-3.6	-3.4	-2.4
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (1000, single-family resales plus 97 percent of single-family starts)	4.718	4.536	4.473	4.122	4.263	4.326	4.407	4.447	4.254	4.717	4.455	4.279	4.581
Percent change -- year ago	1.3	-3.5	-10.8	-14.7	-9.6	-4.6	-1.5	7.9	8.6	10.9	-5.6	-3.9	7.0
Existing Single-family Home Sales (1000)	3.610	3.430	3.349	3.103	3.188	3.247	3.303	3.343	3.214	3.565	3.316	3.210	3.460
Percent change -- year ago	3.8	-4.4	-13.9	-14.2	-11.7	-5.3	-1.4	7.7	12.1	10.9	-7.0	-3.2	7.8
Housing Starts	1611.7	1621.7	1608.7	1547.6	1461.7	1508.8	1569.4	1602.7	1742.3	1819.2	1659.2	1521.9	1631.7
Percent change -- year ago	-14.2	-7.8	-5.5	-13.8	-9.3	-7.0	-2.4	3.6	-1.4	4.4	-8.8	-8.3	7.2
Single-Family Units	1142.0	1140.7	1158.3	1050.9	1107.9	1112.7	1138.0	1137.9	1072.6	1188.1	1174.2	1102.4	1155.6
Percent change -- year ago	-6.2	-0.8	0.0	-16.3	-3.0	-2.4	-1.8	8.3	-2.4	10.8	-1.2	-6.1	4.8
Multi-Family Units	469.7	481.0	450.5	496.7	353.8	396.1	431.4	464.9	669.7	631.2	485.0	419.5	476.2
2-4 Family Units	73.0	58.0	54.3	59.9	42.7	47.8	52.0	56.1	93.4	85.4	66.3	50.6	57.4
Percent change -- year ago	-9.9	-24.3	-38.3	-25.1	-41.6	-17.6	-4.2	-6.4	-23.3	-8.6	-22.3	-23.7	13.5
5+ Family Units	396.7	423.0	396.1	436.8	311.1	348.3	379.4	408.8	576.2	545.8	418.7	368.9	418.7
Percent change -- year ago	-31.6	-20.4	-13.1	-4.8	-21.6	-17.7	-4.2	-6.4	5.5	-5.3	-23.3	-11.9	13.5
New Single-family Home Sales (1000)	674	674	650	634	610	620	655	679	749	685	681	630	700
Percent change -- year ago	-15.1	-1.7	-8.6	-12.3	-9.5	-8.0	0.8	7.1	17.2	-8.5	-0.6	-7.5	11.1
Mobile Homes Shipped (1000)	227	237	242	232	241	244	250	252	283	249	235	242	258
HOME PRICES													
Existing Home Prices - Median ($1000)	85.1	85.0	84.1	86.2	88.5	89.8	89.7	92.3	75.5	80.3	84.6	88.6	93.0
Percent change -- year ago	3.8	5.3	4.9	2.3	4.0	5.6	6.7	7.1	4.3	6.4	5.4	4.7	5.0
New Home Prices - Median ($1000)	103.5	108.7	112.0	110.0	105.0	107.6	105.9	108.7	84.3	92.0	105.4	109.9	114.9
Percent change -- year ago	12.6	16.2	17.7	13.0	1.5	-1.0	-5.4	-1.2	5.5	9.1	14.6	4.3	4.5
FINANCIAL MARKETS													
Long-Term Interest Rates (%)													
30-year Fixed Rate Mortgage (FHA Secondary)	10.3	10.7	10.6	11.0	10.8	10.6	10.4	10.5	12.2	9.9	10.1	10.7	10.6
1-year ARM (without buydown)	8.1	8.3	8.2	8.4	8.4	8.2	8.2	8.2	7.6	7.9	8.2	8.3	8.2
Corporate AAA Bond Rate	9.2	9.8	10.2	9.8	9.5	9.5	9.5	9.6	11.4	9.0	9.4	9.6	9.6
Government Bond Rate	8.5	9.1	9.1	8.6	8.2	8.3	8.2	8.4	10.8	7.8	8.6	8.3	8.6
Federal Funds Rate	6.7	6.8	7.1	6.5	6.3	6.4	6.6	6.7	8.1	6.8	6.7	6.4	6.9
3-month T-Bill Rate	5.7	6.0	6.0	5.3	5.2	5.3	5.4	5.5	7.5	6.0	5.8	5.3	5.7
Prime Rate	8.0	8.4	8.9	8.4	8.0	7.6	7.4	7.4	9.9	8.3	8.2	7.8	7.7
Discount Rate	5.5	5.7	5.8	5.6	5.1	5.1	5.2	5.2	7.7	6.3	5.6	5.2	5.3
Money Supply (M1)(% change)	6.5	-0.1	5.6	8.0	7.8	7.2	7.4	6.7	11.9	15.2	6.5	7.6	6.2
Value of the U.S. Dollar (Trade-Weighted Avg.)	97.0	98.7	96.4	95.4	92.9	91.4	89.9	143.2	143.2	112.3	98.0	92.4	89.0
Percent Change	-11.1	7.2	-8.7	-4.3	-9.9	-6.3	-6.4	-1.8	-12.9	-21.6	-12.7	-5.7	-3.7

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE OUTLOOK

Vol. 1, No. 1

January 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The third quarter annual growth rate of real GNP was revised upward to 4.1 percent on the basis of stronger business fixed investment spending and faster net export growth. This report confirmed the momentum in the U.S. economy prior to the stock market crash.
- Post-crash economic indicators suggest the economy may be shrugging off the effects of the stock plunge sooner than anticipated. Among the positive indicators: substantial employment gains, growing U.S. exports and a higher rate of industrial production.
- Real GNP growth should rise slowly in the first half of 1988 reflecting the adverse effects of the stock plunge. Growth in net exports should propel the economy out of this sluggish period and into a stronger second half. Overall, real GNP growth in 1988 could slow to a 2.2 percent rate compared to the 2.8 percent rate of 1987.
- Inflation is expected to average about 4.4 percent through 1988, as the dollar declines further to shrink the trade deficit, but ultimately raising consumer prices at home.
- Mortgage rates are expected to trend down modestly through 1988, but staying above 10 percent. The average rate on a 30 year FRM is expected to be about 10.6 percent in 1988.
- Sales of existing single-family homes will slow to an average annual rate of 3.2 million units in the first half of 1988, and 3.3 million units in the latter half. For all of 1988, existing single-family home sales will average 3.24 million units, an 8 percent decline from the 1987 estimated rate of 3.52 million units.
- Housing starts should also decline in 1988, to about 1.52 million units, down almost 8 percent from the 1987 estimated annual rate of 1.65 million units. Single-family starts are expected to fall 6 percent to 1.1 million units in 1988, from 1.17 million units in 1987.

IN THIS ISSUE

- **Economic Commentary: THE RETURN OF COMET HALLEY, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Federal Budget Update: Taxing & Spending Washington Style, by Frederick E. Flick**
- **Special Topic: Profile of Real Estate Practitioners, by John C. Keaton**

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THE RETURN OF COMET HALLEY:
Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

At this time three years ago, comet-mania was just sinking into the American consciousness. We were eagerly awaiting the reappearance of comet Halley after its 75-year tour of the outer reaches of the universe. Our material nature led to the production of T-shirts and other memorabilia; our spiritual sides focused on the dire consequences that would attend such an infrequent celestial event. But both sides agreed that it would be a big, meaningful deal. You know what? It wasn't. The great comet appeared as a dim light just above the horizon and had virtually no effect on the course of the world.

Well, welcome to those thrilling days of yesteryear. We have produced another comet Halley in the form of the stock market crash. We expected that the economy would collapse, that the world we knew would be shattered. In reality, the events of mid-October will, like comet Halley, affect only those who get caught up in the mania. We expected a bang, but we got a whimper.

Since the crash, the economic news has been good to mixed. Consumer confidence appears to be down since the crash (but has not been shattered); housing starts and new home sales are down. But, durable goods orders rose in October, and employment increased in both October and November.

I think there are two points to be made here. First, it is too early to tell whether the stock market collapse will significantly reduce economic growth. All our third quarter numbers point to significant underlying strength in the economy at large. Right now, that strength appears to be enough to overcome the crushing blow to confidence administered by Wall Street. As we move into the first quarter of 1988, the outcome of this struggle will become apparent.

The second point deals with the comparisons between 1987 and 1929. Surely, we have in both periods a booming economy with several depressed sectors, a hotly speculative stock market and significant foreign trade problems. But there is one major difference. Clearly, the MVP of the Crash of '87 has to be the Fed. Unlike 1929, when the monetary authorities snatched defeat from the jaws of victory by sucking liquidity out of an economy in sore need of it, the Fed in 1987 opened wide the lending window and provided the funds that kept a crash from becoming a depression. And just as important, after the initial shocks subsided, the Fed dried up this extra liquidity to prevent the development of excess inflation. In all, a textbook case of policy execution.

But, given that this is a time of uncertainty, where should one look to divine the future? Perhaps focusing in on four major numbers will be helpful.

1. The Dow-Jones Average. The D-J has never been a measure of real economic activity, but it serves as a psychological indicator that may affect economic behavior. Currently, the Dow is about where it was a year ago (and about 650 points above where it was when comet Halley attempted to reappear). If it consistently moves within a 50-100 point range of its current level, then the strength of the economy will prevail. The October episode will have served to wring excess speculation out of the market with little ultimate impact.

2. The Dollar v. Interest Rates. The falling dollar will stimulate production but will lead to higher inflation; falling interest rates will stimulate production and may lead to more inflation. Clearly, the economy will be strong if both the dollar and rates drift downward. Should the dollar go into freefall, we could easily lapse into a 70's-style stagflation. At its present pace, the fall in the dollar will lead to higher growth in 1988.

3. Consumer Confidence. Post-October 19 polls show a significant drop in consumer confidence, but far short of disaster. In addition, Christmas sales appear to be down only slightly. Two consecutive months of drops in consumer expenditure exceeding 0.5 percent, with no improvement in confidence indices, will signal that the stock market collapse was an early indicator of recession.

4. Leading Indicators. The Index of Leading Indicators has been a much maligned economic statistic. Currently, the index is falling, largely owing to the inclusion of the Dow-Jones as one of its components. Remove the Dow and the index is rising. Should this trend continue, then the economy will remain strong; a fall (absent the D-J) of three consecutive months will precede a recession.

You can, and ~~should,~~ follow each of these numbers in the press. We believe, as you can see in our forecast, that the stock market crash will dent the economic expansion, but not stop it. In fact, we look for a resurgence of growth in the second half. In effect, we see the events of October as comet Halley, promising much, inspiring awe, but ultimately being less than the momentous event of the decade.

Outlook for the Economy and Real Estate

The first readings on the economy's overall health after the stock market crash are beginning to trickle in and they suggest the pre-crash momentum of the economy may offset some of the anticipated immediate negative effects of the stock market crash. The upshot is that if economic growth continues at the pace set by the new indicators, then the U.S. economy will only experiece a modest economic slowdown in the first half of 1988, thus averting a recession.

The preliminary real GNP annual growth rate for the third quarter had been reported at 3.8 percent but was revised upward to 4.1 percent, confirming the economy's strength in the weeks preceding the market crash. Business fixed investment and net exports, both large contributors to third quarter growth, were found to be even stronger, forcing the upward revision. Alternatively, residential investment was weaker than originally reported, offsetting some of the upward revision.

Post-Crash Indicators

Post-crash indicators are still few and far between, but generally they describe an economy much stronger than was anticipated. The November employment report exactly reversed the October 0.1 percent rise in the unemployment rate, dropping it back down to 5.8 percent. In November, total employment, when measured on a household basis, rose 327 thousand to a nationwide employment total of 115.3 million. Throughout the first 10 months of 1987, monthly employment gains in the household survey had averaged 254 thousand. The establishment survey of payroll employment also recorded a substantial gain: up 247 thousand in November. These gains were widespread including both durable and nondurable goods industries, construction, and the service industries. Further, the factory workweek was calculated to be 41.2 hours long in November, an impressive mark when compared to historical standards. The importance of this positive employment report is twofold: it shows the economy is still creating thousands of jobs, and it implies that rising U.S. exports are fostering greater employment here.

Further proof of the positive impact export growth is having on U.S. industry can be found in the November industrial production index which rose 0.4 percent in that month, after strongly advancing 0.9 percent in the October report. Like the employment numbers, the output gains were spread across many industries. Production of home goods and business equipment showed considerable strength, while auto industry output posted a decline.

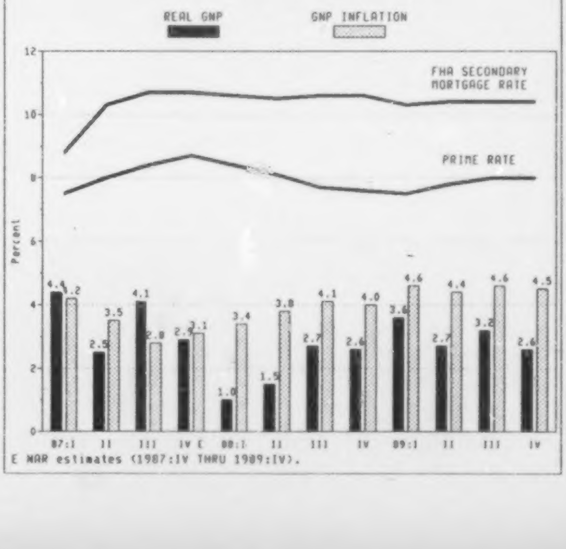
Producer price inflation remains very modest. Recent monthly reports have shown the index rising by small increments. In November, the producer price index for finished goods was unchanged, compared to a fall of 0.2 percent in October. Intermediate goods prices have been rising faster in recent months, with the November index for these goods rising 0.4 percent. Crude goods prices fell by 1.7 percent in November, the second monthly decline in three months, and a reversal of an eight month trend of increasing crude goods prices. According to this data, inflation does not seem to be creeping in through the domestic production process, despite rising industrial production and higher capacity utilization rates.

The preliminary report on November retail sales registered a 0.2 percent increase after two consecutive monthly declines. However, the September and October figures were revised down substantially, to -0.9 percent and -1.7 percent, respectively. Slower automobile sales in November were partly to blame for the meager 0.2 percent rise. Excluding sales at automotive stores, retail sales rose 0.4 percent in November.

The 1988 Outlook

The economic outlook for 1988 framed by these indicators and the pre-crash economic momentum is depicted in Graph 1. While not falling into a recession, real GNP growth could rise by an average annual rate of 1.3 percent in the first half of 1988, a good deal slower than the 3.5 percent rate in the first half of 1986. The positive contribution of net exports during the first half of 1988 will keep the economy out of a recession, and lead it to a more robust second half average annual growth rate of 2.7 percent. Inflation (as measured by the GNP deflator) should increase moderately over the course of 1988, although this seems inconsistent with a slow growth forecast. In fact, inflation will continue to be driven by the declining value of the dollar rather than by an expanding economy. Fears of rising inflation will probably keep mortgage rates above the 10 percent mark through much of the year. On the short side, the prime rate could test the seven percent level again next year as the monetary authority helps avert a recession by using lower interest rates to stimulate the economy.

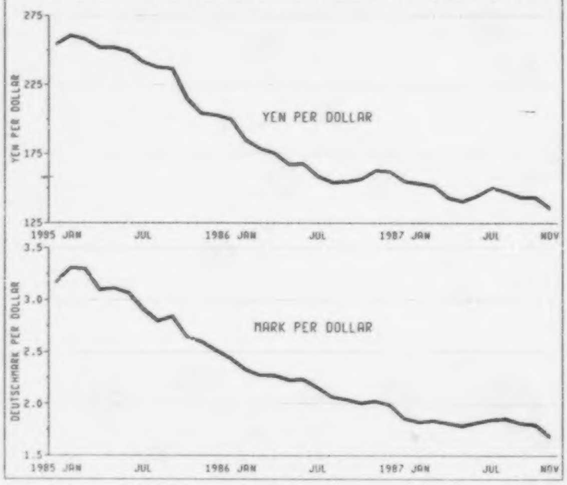
GRAPH 1: THE ECONOMIC OUTLOOK



E MAR estimates (1987:IV THRU 1989:IV).

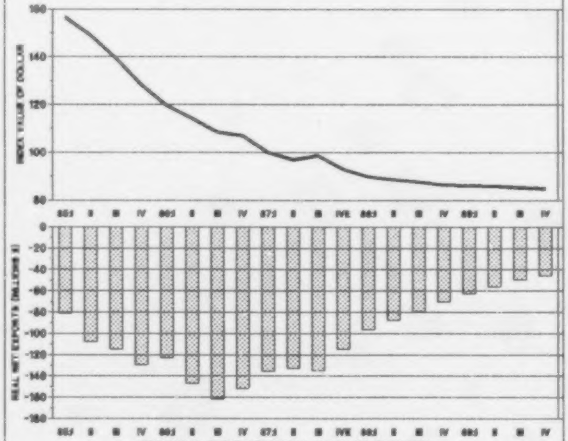
The success of virtually every economic forecast for 1988 lies in the assumptions regarding the value of the dollar. Graph 2 presents the fall in the dollar's value since February 1985 in both Japanese yen and W. German deutschmark terms. Early in 1987, the dollar's slide seemed to be nearing a point of stabilization, that was expected to be followed by further orderly and slow declines. These hopes were dashed in late March in a sort of chicken or the egg scenario where financial market participants debated if government reports of high inflation were already fully accounted for in the dollar's present value. The naysayers won out and the dollar tumbled, teaching a timely lesson about the new links between domestic mortgage rates and world asset prices, particularly mortgage-backed securities.

GRAPH 2: THE DOLLAR'S FALL SINCE FEBRUARY 1985



This forecast projects the dollar to decline by an additional 10 percent or more during 1988. Graph 3 not only shows this downward trend, but it also points out why the dollar must continue to fall. That is, not only will the dollar be forced down in value during 1988 by investors unwilling to hold dollar-denominated assets at the current exchange rate, but it must fall further to spur on improvement in the U.S. trade deficit. The effect of these improvements in U.S. trade performance is best measured by real (inflation-adjusted) net exports (exports minus imports). The graph shows that real net exports had been improving steadily since the third quarter of 1986, until they worsened slightly in the third quarter of 1987. This forecast projects further steady improvements in real net exports not only from the additional 10 percent depreciation of the dollar in 1988, but also from the lagged effect currency changes have on real trade flows.

GRAPH 3: THE LOWER DOLLAR...



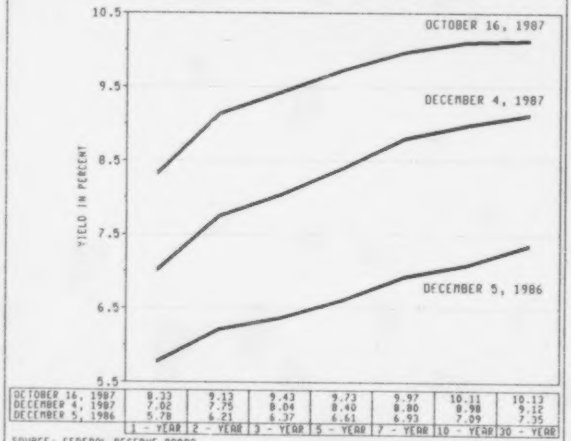
SHOULD BOOST REAL NET EXPORTS

E- NAR estimates.

MONETARY POLICY AND INTEREST RATES

The Federal Reserve, as the monetary authority, has had the unenviable task of balancing the demand for liquidity immediately following the stock market plunge against the potential for inflation fears to sweep through the financial markets. With the addition of so much liquidity to the financial system, yields on instruments of virtually all maturities have fallen since the week ending October 16, 1987. On Graph 4, this is shown by a complete shift down in the yield curve from the top line to the middle line. The bottom line shows how the yield curve looked one year prior to the most recent data available. In 1988, this forecast projects that the yield curve will often reside between the December 1986 and December 1987 curves. Although the Fed appears to have mopped up the extra liquidity it pumped into the economy since the stock market plunge, it seems unlikely that it will risk a recession by keeping interest rates high.

GRAPH 4: YIELDS ARE FALLING FOR ALL MATURITIES
(RATES ARE FOR U.S. TREASURY CONSTANT MATURITY ISSUES)



	1 - YEAR	2 - YEAR	3 - YEAR	5 - YEAR	7 - YEAR	10 - YEAR	30 - YEAR
OCTOBER 16, 1987	8.33	9.13	9.43	9.73	9.97	10.11	10.13
DECEMBER 4, 1987	7.02	7.75	8.04	8.40	8.80	8.98	9.12
DECEMBER 5, 1986	5.78	6.21	6.37	6.61	6.93	7.09	7.35

SOURCE: FEDERAL RESERVE BOARD.

Graph 5 presents the current forecast for short-term interest rates. Following on the actions of the Fed to increase liquidity in the days following October 19, commercial banks lowered the prime rate in steps to 8.75 by the second week in November. From there, this forecast projects the prime rate to trend downward as the Fed acts to spark economic growth in the face of an economic downturn. As economic growth returns in the second half of 1988 and on into 1989, the prime rate and other short-term rates could begin to trend upwards. At present, the policy of the Fed appears to be to allow short-term rates to remain somewhat high through the end of 1987, before it has to act to force them down in the slow growth environment of the first half of 1988. As part of that expected policy move in the first half of 1988, the Fed might lower the discount rate to 5.75 percent and then 5.5 percent.

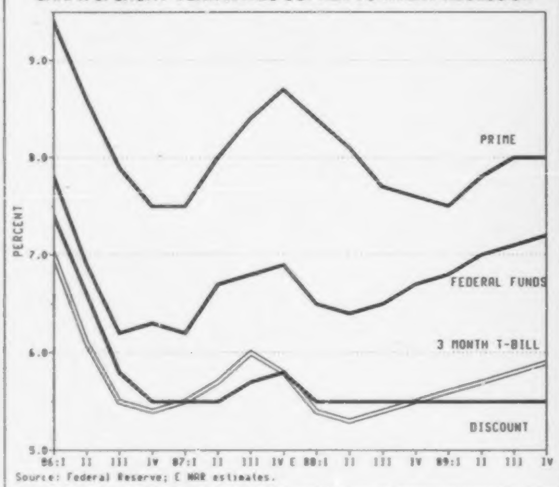
The forecast for long-term interest rates is presented in Graph 6. After falling below 9.0 percent for one brief but delightful quarter in early 1987, they immediately shot up by 150 basis points, largely on fears of inflation brought on by uncertainty surrounding the U.S. dollar. Mortgage rates surged again during the summer of 1987, but it took an event like the stock market crash to shake them loose from the 11.0 percent level. Since the market collapse, long-term rates have drifted downward, at first rather quickly, but ultimately much more slowly than their rapid ascension of the spring and summer. The current forecast projects a modest bond market rally through the first half of 1988. The rally could bring 30 year Treasury bond yields down below 8.5 percent, and mortgage rates to below 10.5 percent. Yields are not expected to remain at those levels for long, however. Instead, a stronger economy in the latter half of 1988 could prevent further declines in long-term rates and possibly touch off some modest increases.

REAL ESTATE MARKETS

Housing Starts

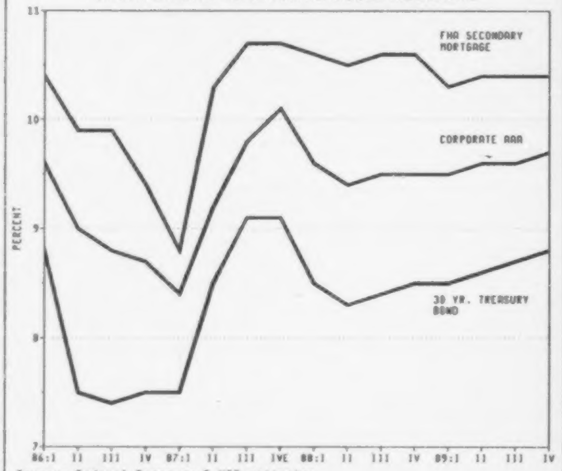
In November, housing starts posted an annual rate of 1.637 million units, a 7.5 percent increase over the October annual rate of 1.523 million units. However, single-family units were started at an annual rate of 1.119 million units in November, only 1.5 percent faster than the October annual rate of 1.102 million units. The multi-family start rate, which is subject to large fluctuations, rose to an annual rate of 518 thousand units, 23 percent above the October rate of 421 thousand units. The 1988 forecast projects single-family homes to be started at an average annual rate of 1.1 million units, 6 percent below the estimated 1.174 million rate of 1987. Multi-family starts could total 420 thousand units in 1988, 12 percent below the 476 thousand unit pace of 1987. Total housing starts would thus reach 1.52 million units in 1988, 8 percent below the 1987 rate.

GRAPH 5: SHORT-TERM RATES SOFTEN TO AVERT RECESSION



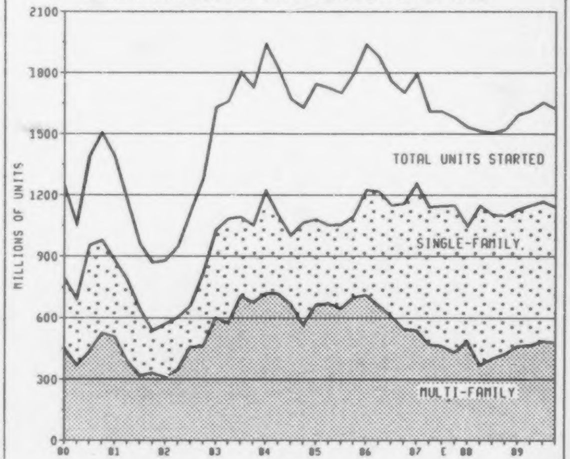
Source: Federal Reserve; E NAR estimates.

GRAPH 6: LONG-TERM RATES COULD MODERATE



Source: Federal Reserve; E NAR estimates

GRAPH 7: HOUSING STARTS SLOWER IN 1988

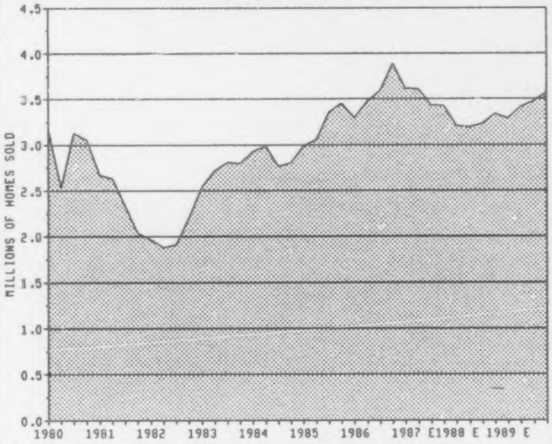


Source: Bureau of Census; E NAR estimates.

Existing Home Sales

Existing single-family homes were sold at the surprisingly strong annual rate of 3.56 million units in October 1987, the most recent data available. This represented a 3.2 percent gain over the September 1987 rate of 3.45 million units, and a 5.3 percent decline from the 3.76 million unit rate of October 1986. During the first 10 months of 1987, existing homes were sold at the average annual rate of 3.55 million units. Home sales increased in every region of the country during October 1987, but the 10.5 percent gain in the West region was the largest rise. The impact of the stock market collapse may not be observed in the EHS data series until the first quarter of 1988 (see Graph 8), when the combined forces of a weak economy and expectations of even lower interest rates keep many potential homebuyers on the sidelines. Existing home sales could fall to 3.2 million units in the first half of 1988, before rising in the second half for an average annual rate of 3.24 million homes sold in all of 1988.

GRAPH 8: EXISTING SINGLE-FAMILY HOME SALES SOFTEN IN 1988
(Seasonally Adjusted Annual Rates)

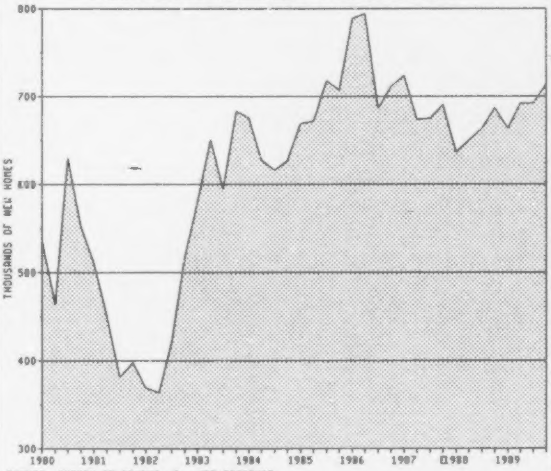


SOURCE: NAR ECONOMICS & RESEARCH, E - NAR FORECASTING & POLICY

New Home Sales

The annual rate of new single-family home sales (speculative only, not including custom built homes) declined for the second straight month to 657 thousand units in October, the most recent data available. The October rate was 1.5 percent below the September annual rate of 667 thousand units, and 2.7 percent below the October 1986 annual rate of 675 thousand units. Many potential new home buyers have fled the new home market due to high monthly payments brought on by mortgage rate increases in 1987 and a more expensive product supplied by builders. Consequently, existing home sales have reached a 1987 annual rate almost identical to the 1986 level. In contrast, new home sales through ten months of 1987 averaged only 688 thousand units, 8.1 percent below the 1986 rate of 749 thousand units. Graph 9 shows the current forecast which projects new single-family home sales to fall 4 percent in 1988 to 659 thousand units, before rising 5 percent in 1989.

GRAPH 9: NEW HOME SALES SLUGGISH IN 1988

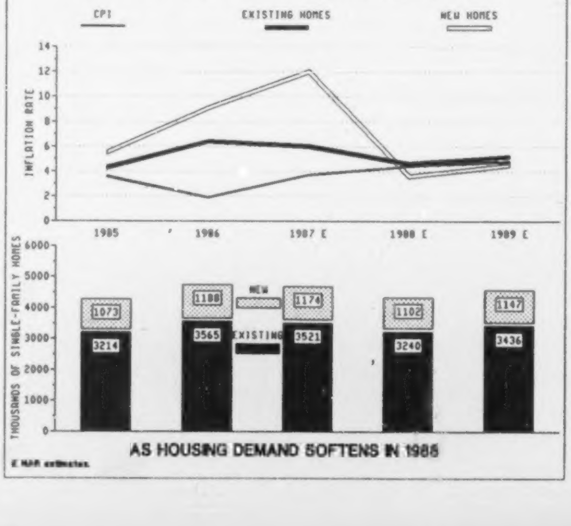


SOURCE: BUREAU OF CENSUS; E - NAR FORECAST.

Home Prices

The median existing home price appears to have risen to $85,100 in 1987, a 6.0 percent gain over the $80,300 median price in 1986. Graph 10 presents the current forecast in which a softening in housing demand in 1988 leads to slower price increases. Existing homes should continue to increase in real terms through both 1988 and 1989, a feat new homes will find difficult to duplicate. The 1987 median new home price appears to have risen to about $103,000, a 12 percent increase over the 1986 median new home price of $92,000. New home prices will probably rise by only about 3.6 percent to $106,700 in 1988, due partly to continued weakness in new home sales brought on by the large price increases of 1987. But part of the large 1987 price increase was due to fewer buyers on the lower side of the income spectrum, and more higher income buyers who normally purchase more expensive homes.

GRAPH 10: HOME PRICE APPRECIATION MAY SLOW...



AS HOUSING DEMAND SOFTENS IN 1988

E NAR estimates.

TAXING AND SPENDING WASHINGTON STYLE:
A Closing View of the FY 1988 Budget Process

by
Frederick E. Flick
Division Vice President
Forecasting and Policy Analysis

This is the season for consumers to be taxing their patience, while spending their money at the long cashier lines in department stores. However, it is also the period just before the Congressional holiday recess and our national lawmakers are taxing and spending as well. Except for the recent Gorbachev - Reagan Summit interlude, the White House and Congress have been focused on calming jittery financial markets since the October 19 stock market crash. In practice, this has become the substantive task of providing a budget for the U.S. Government, and implementing the recent budget accord which provides Fiscal Year 1988 deficit reduction figures which are greater than the $23 billion provided by the Gramm-Rudman-Hollings(GRH)targets.

In this segment of our Real Estate Outlook, we examine the making of the FY 1988 discretionary spending budget, which is expected to be a major influence on the economy and financial markets in 1988. An important part of this influence will be the budget accord, or compromise on spending and taxation worked out between the President and Congress this fall. This deal has been struck to allow circumvention of the Gramm-Rudman-Hollings mandated budget cuts. However, a necessary step was that the president by law had to sign the November 20 GRH sequestration order because Congress and the President could not agree in time on legislation to avoid the required across-the-board expenditure cuts. Through parliamentary maneuvering, Congress still has until mid-December to enact the details of the budget accord and circumvent the automatic implementation of the GRH cuts.

Most importantly, the stock market crash crystallized in the minds of the President and Congress the necessity of supporting compromise legislation that included both spending cuts and tax increases. Prior to this event, the President had repeated his adamant opposition to any legislation involving tax increases. In this case, by accepting some revenue raisers, he was able to obtain a lower cut in defense outlays. Those in Congress who wanted higher levels of nonmilitary spending were able to maintain this through the proposed higher tax collections. Thus, everybody seems to get something out of the agreement.

The Budget Accord

The agreement hammered out by the White House and Congress provides for $30.2 billion in deficit reduction in fiscal 1988 and $45.9 billion in fiscal 1989, with the FY 1989 figures renegotiated as part of next year's budget process. (The GRH sequestrations would have provided only $23 billion in FY 1988.) The accord provides for $9 billion in new taxes in FY 1988 ($14 billion in FY 1989), combined with FY 1988 spending cuts of $5 billion from defense, $2.6 billion from domestic accounts, $4 billion from various entitlements (including Medicare), $2 billion from increased IRS enforcement and user fees, and $6.5 billion from government asset sales and reduced debt service. (See Table 1.)

The Next Steps in the Process

Ultimately, both houses of Congress need to pass, and the President must sign, reconciliation legislation which will incorporate spending (appropriations) and tax provisions that are consistent with the accord. Prior to that final step, the House and Senate each will pass their own versions of tax and spending legislation, with the job of a joint conference committee to reconcile any differences into one package consistent with the accord.

The Progress of the House Budget

On October 29, the House passed a reconciliation bill (involving both taxes and spending), including about $14.3 billion in new taxes, of which $12 billion would be used for deficit reduction.

The most important revenue increase changes in the House tax bill (FY 1988 amounts in parentheses, if available) include:

- 100 percent of the excess of book income or adjusted current earnings over other alternative minimum tax (AMT) income would be a preference for corporate taxpayers. The current 20 percent AMT tax rate would be retained ($2.8 billion);
- Provisions to maintain tax-favored treatment for master limited partnerships in energy, natural resources, and real estate. Income from MLPs that do not engage in active business activities will be considered portfolio income for purposes of the passive loss rules. The partnership level audit rules would apply to publicly offered partnerships ($0.1 billion);
- Limit to $1 million the amount of mortgage principal on which interest payments would remain deductible (less than $50 million);
- Home equity loans on which interest is deductible would be limited to $100,000 for married taxpayers and $60,000 for single filers. Boats and mobile homes used on a transient basis would not qualify as second residences for purposes of the deductions (less than $50 million);

- Limit the deferral of tax liability for like-kind exchange capital gains for real estate to $100,000 annually; and,
- Subject the investment income of Section 501(c)(6) trade associations (i.e., local boards and REALTOR® Associations) to the unrelated business income tax except to the extent that income is set aside for charitable purposes, and except for gain on certain dispositions of assets used in performing exempt purposes.

The October negotiations between the White House and Congress precluded the presence of any revenue loss provisions in any final tax legislation. Since the measure reported out of the House Ways and Means Committee violated this part of the agreement, the reconciliation bill only passed by one vote.

The recently approved House spending bill provides $587 billion to fund the federal government through the end of the fiscal year. However, the provisions on the spending side exceed the non-military component agreed to in the budget accord by more than $2.6 billion. Furthermore, the amount of military spending in the bill is $1.1 billion less than that agreed to in the accord. Thus, there are still these details to be worked out.

The current House passed omnibus spending bill combines 13 separate appropriations bills to fund the government. During the House-Senate joint conference reconciliations, the entire government budget will be worked over to be consistent with the accord's limits of $285.4 billion for military spending and $176.8 for non-military spending in FY 1988.

The Progress from the Senate Side

On October 16, the Senate Finance Committee approved a package of tax increases that would have raised more revenue than eventually negotiated in the accord. However, the events of the next few days, and the reactions of the White House and Congress, caused the Senate to shelve further work on taxing and spending. By December 3, the Senate Budget Committee had produced a reconciliation bill and the Senate Finance Committee had passed a $9 billion package of tax increases for FY 1988. Separately, the Senate Appropriations Committee, on December 3, approved an omnibus discretionary spending bill for $600 billion in FY 1988 which would account for $7.6 billion in budget savings.

By December 10, the Senate had approved the budget accord provisions and, at that point, the combination of the Budget, Appropriations, and Finance Committee's bills were put into a reconciliation bill that would cut $33.7 billion from the projected fiscal 1988 deficit.

A further confounding influence on this side of the process involves the White House's concerns with some aspects of the Senate reconciliation bill. The Administration endorsed most of the components on the appropriations legislation but still did not like three components relating to rural electrification loan refinancing, reductions in farm-subsidy loan rates, and reinstatement of the fairness doctrine for broadcasting. At this point, however, there were not major real estate problem areas in the Senate approved taxing and spending bill.

The Senate Reconciliation Bill

The Senate bill involves a $9 billion tax increase, and would provide for $26 billion in deficit reduction in FY 1988. The tax and spending bills combined would reduce the deficit by $33 billion - $3 billion more than the accord calls for. Furthermore, the spending bill would provide $6 billion in savings from a variety of federal programs, including $2 billion from Medicare, $1.2 billion in farm subsidies, and $1 billion in veterans loan programs.

The tax component of the bill would raise $9 billion in revenue through minor corporate tax increases and the closing of an estate tax loophole related to employee stock ownership plans (ESOPs). Specific major provisions of the budget reconciliation bill include:

- The telephone excise tax would be extended for three years, for a gain of $3.6 billion over the next two years;
- The corporate estimated tax payment rules would be changed to raise $2.3 billion over the next two years;
- The 1986 Act's ESOP/estate tax loophole would be closed for a gain of $2.7 billion over the next two years;
- Repeal of the installment method of accounting for dealers; restoration of the pre-1986 installment sales provisions for non-dealers to yield increased revenues of $4.6 billion over the next two years;
- Freeze the estate and gift tax at the top rate of 55 percent, rather than allowing it to fall to 50 percent next year (less than $50 million);
- Corporate deductions for additions to vacation pay reserves would be disallowed for a two-year revenue gain of $3.9 billion.

(See Table 2, for provisions common to both bills.)

Where It All Stands

The Congress should complete the joint House-Senate Conference reconciliation by late-December just in time for the holidays. Of course, this legislation is for fiscal 1988, which began almost three months ago. Although the conference agreement may project savings for FY 1989 as well, specific items will be renegotiated next year at about this same time.

Regarding the real estate industry, the worst tax provisions are in the House reconciliation measure. These include:

- Placing a $1 million cap on the principal against which mortgage interest would be deductible;
- Loss of deferral to tax liability on the gain from like-kind exchange of real property;
- Restrictions on home equity loan interest deductibility; and,
- Provisions subjecting trade association net investment income to the unrelated business income tax.

As the House-Senate Conference works to resolve these issues, the Administration will still be pressing for changes in programs and policies, but these will have relatively minor effects on the goals worked out in the budget accord.

It appears likely that, by the end of the calendar year the Congress will provide the President with a completed budget. But this is far from the end: the FY 1989 process will begin anew in early spring. After a short hiatus between New Year's and Super Sunday, the bureaucrats and politicians will be gearing up for the FY 1989 process. Thus, taxing and spending Washington style is an on-going feature of life in the shining city on the hill.

Table 1
A COMPARISON OF REVENUES AND SPENDING CUTS FROM THE BUDGET ACCORD VERSUS GRAMM-RUDMAN

	BUDGET ACCORD	GRAMM-RUDMAN
REVENUES:		
Tax Increases	9.0	0
User Fee Increases	0.4	0
IRS Enforcement	1.6	0
Refinancing of REA loans*	5.0	0
Pension savings	0.4	0
VA loan fee	0.2	0
VA loan guarantees	0.8	0
Total Revenues	17.4	0
SPENDING CUTS:		
Military programs	5.0	11.50
Domestic programs	2.6	9.48
Entitlement programs		
Medicare cuts	2.0	1.4
Farm subsidies	0.9	0.6
Student loans	0.25	0.02
Government personnel	0.85	0
Interest on federal debt	1.2	0
Total Spending Cuts	12.8	23.0
TOTAL BUDGET SAVINGS	30.2	23.0
	= = = =	= = = =

*Rural Electrification Administration

Sources: Office of Management and Budget and Congressional Budget Office

Table 2

REVENUE ESTIMATES FROM COMMON PROVISIONS IN THE HOUSE AND SENATE TAX BILLS

	FY 1988	FY 1989	FY 1988-90
Accounting			
Repeal completed contract method	0.8	1.5	4.4
Repeal of vacation pay reserve	0.1	0.1	0.2
Amortization of customer base intangibles	0.1	0.1	0.3
Estimated Tax			
Estimated Tax Penalty Relief for 1987	--	--	--
Corporate Estimated Tax Reform	1.8	0.4	2.5
Master Limited Partnerships:			
PortfolioIncome	0.1	0.1	0.4
Corporate Tax Provisions			
Modify computation of earnings and profits for intercorporate dividends and basis adjustments	0.3	0.4	1.1
Limit consolidated return passthrough	0.2	0.4	1.0
Repeal graduated tax rates for personal servicecorporations	0.1	0.1	0.3
Reduction of tax avoidance in certain corporatedispositions	0.3	0.4	1.3
Pensions: Limit funding of overfunded pension plans	0.6	1.8	3.9
Estate and Gift Tax			
Freeze 55 percent tax rate	+	0.2	0.4
ESOP estate tax deduction	1.3	1.5	4.8
Excise Taxes			
Telephone excise tax: 3-year extension	1.3	2.6	6.0
Collection of diesel fuel and special motor fuels taxes on sales to retailers	0.2	0.2	0.6
Employment Taxes			
Railroad Retirement Tax	0.1	0.2	0.5
Extend FUTA repayment tax	0.7	1.0	2.8
Certain User Fees			
Internal Revenue Service	+	0.1	0.2
Bureau of Alcohol, Tobacco, and Firearms	0.1	0.1	0.4
Customs Service	0.3	0.3	1.0
	= = =	= = = =	= = = =
TOTAL	8.5	11.5	32.1

-- Revenue decrease less than $50 million.
+ Revenue increase less than $50 million.

Source: Tax Notes, November 23, 1987, p. 760 (Published by Tax Analysts, Arlington, VA)

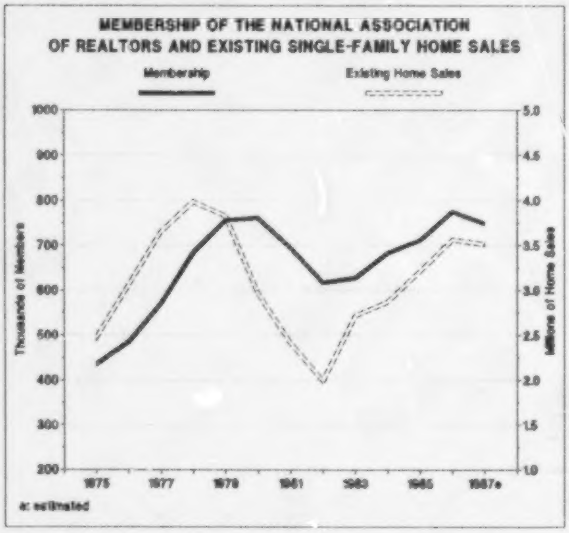
SPECIAL TOPIC:
PROFILE OF REAL ESTATE PRACTITIONERS

There have been significant changes in the profile of the membership of the NATIONAL ASSOCIATION OF REALTORS® over the past three years. These changes are evident in a recently published report entitled Membership Profile 1987. The report is based on a Spring 1987 survey to which more than 2,900 real estate brokers and salespersons responded. Following are some highlights from the report.

Market Conditions at the Time of the Survey Were Good

Real estate markets in general, and single-family home sales in particular, were healthy during 1986 and 1987. At the time of the survey, existing single-family home sales were running at an annual rate in the 3.5 to 3.7 million range, and were well ahead of the nearly 2.9 million homes that were sold in 1984—when the last profile was developed. Similarly, the dollar volume of home sales had grown by almost 60 percent over the same time period. Since residential brokerage is the primary business specialty of more than three-fourths of the Association's members, it is not too surprising that home sales market conditions greatly impact the National Association's membership.

The burgeoning market between 1984 and 1987 attracted many new licensees to the industry. The NATIONAL ASSOCIATION OF REALTORS® shared in this boom. Its membership grew from just under 683,000 at year-end 1984 to almost 744,000 at the time of the survey.


MEMBERSHIP OF THE NATIONAL ASSOCIATION OF REALTORS AND EXISTING SINGLE-FAMILY HOME SALES

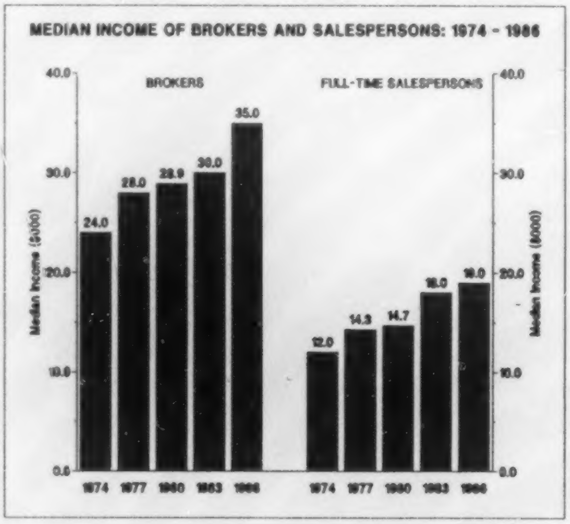
While the Association enjoyed growth in its membership, this growth had its consequences. One major consequence, the entry of so many new sales licensees into the industry, resulted in a very small increase in the average earnings of salespeople. In addition, the median income of salespersons in real dollars dropped between 1983 and 1986, The reason—the lower earnings of this large group of new sales licensees negated income gains made by long-term sales associates. The influence of the new sales licensees also affects other statistics on salespersons.

Another trend which emerged in several parts of the survey is the growing participation of women in real estate. Real estate has traditionally been a profession in which women have been able to compete successfully. The survey found that women now account for a greater proportion of the practitioners than three years ago.

Brokers' Income Up, Full-time Salespersons' Income Little Changed

The impact of improved real estate markets is reflected in the earnings of brokers. In 1986, the median gross personal income of brokers (net of business expenses) was $35,000, almost 17 percent higher than the income reported for 1983. The better real estate market had a different impact on the average earnings of salespersons. A salesperson who worked full time in real estate typically earned $19,000 after business expenses in 1987, six percent higher than in 1983. The small gain in the income of full-time salespersons is due to the lower earnings of newer entrants washing out the gains made by more seasoned veterans of the business.

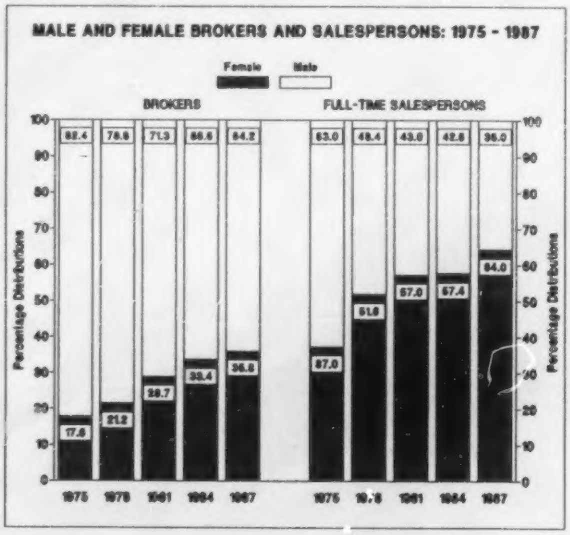
The median income of real estate practitioners compares favorably to the income of people in the U.S. The median income of all persons in the U.S. who are 18 years or older stood at $12,100 in 1986, while the median income of all persons who worked year-round, full-time in 1986 was $21,500.


MEDIAN INCOME OF BROKERS AND SALESPERSONS: 1974 - 1986

Role of Women Continues to Grow

At the time of the survey almost 54 million women were in the U.S. civilian work force--43 percent more than in 1975. Furthermore, the proportion of women in the work force grew from less than 40 percent in 1975 to almost 45 percent at the time of the survey.

Similiarly, the real estate industry has experienced a growing proportion of women in the profession. Nearly 36 percent of the brokers in 1987 are female compared to 12 years ago when females accounted for less than 18 percent of brokers. The proportion of female, full-time salespersons has also risen over the past 12 years.



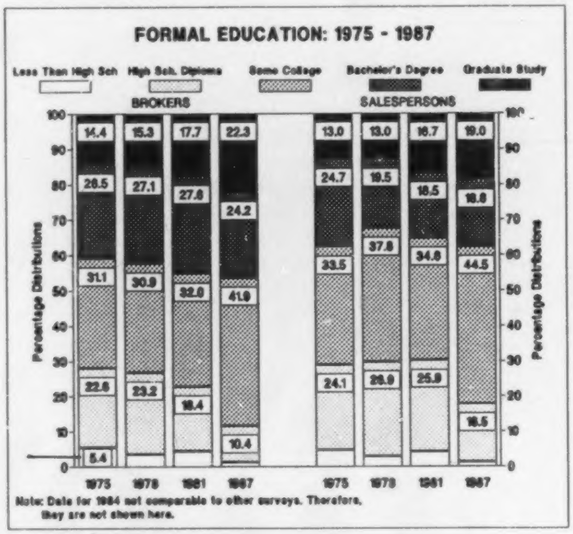
Real Estate Practitioners Are Older than Most Workers

The median age of brokers is 48 years, unchanged from the 1984 survey while the median age of salespersons is 43 years, one year less than in 1984. As a group, real estate practitioners are older than other workers in the U.S. civilian work force who are 18 years or older. The age difference between real estate practitioners and the civilian work force is understandable. Most people do not pick real estate for their first job. The vast majority of real estate practitioners tried their hand at another occupation prior to entering the real estate industry. This explains the older real estate work force.

Educational Attainment Has Improved

Real estate practitioners are very well educated, and their educational attainment has improved over the years. The percentage of brokers and salespersons with a high school diploma or less has declined while the proportion who have a bachelor's degree or more has increased.

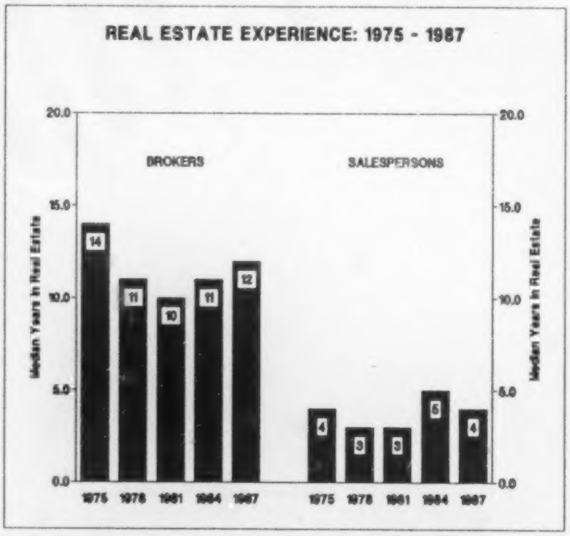
Generally, real estate professionals have completed higher levels of formal education than most U.S. workers. For example, fewer than two out of every ten U.S. workers has a bachelor's degree or more compared to 46.5 percent of brokers and 37.8 percent of salespersons.



Note: Data for 1984 not comparable to other surveys. Therefore, they are not shown here.

Real Estate Experience--Up for Brokers, Down for Salespersons

The real estate experience of brokers has increased since 1981, while the experience level of salespersons has declined. The median years in the business of brokers rose from 10 years in 1981 to 12 years in 1987. Salespersons, on the other hand, have typically been in the business for four years--down from five in the last survey. The latter finding reflects the surge of new sales licensees entering the business.



Single-Family Home Sales Is the Main Source of Income

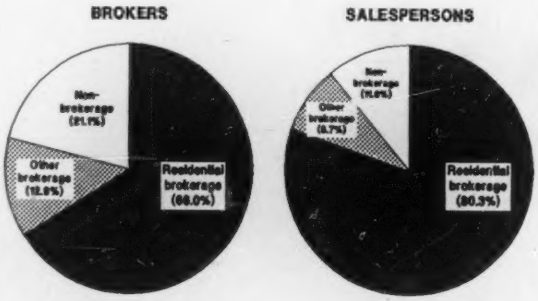
Residential brokerage is the activity in which most members spend at least some of their time. Roughly nine out of every ten brokers and salespersons devote at least part of their time to selling homes.

Commercial brokerage, farm and land brokerage, property management, mortgage finance, appraising and counseling are also frequently mentioned activities in which practitioners are involved to some extent.

The importance of home sales to real estate practitioners is further evidenced by the finding that residential brokerage continues to be the primary business specialty of brokers and salespersons. Two-thirds of the brokers and eight out of every ten salespersons list residential brokerage as their bread-and-butter activity.

PRIMARY BUSINESS SPECIALTY: 1987

(Percentage Distributions)

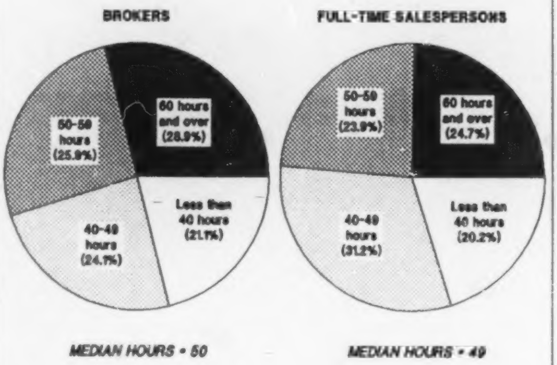


Real Estate Practitioners Put In Long Hours and Work Weekends

Working in real estate is not a profession for someone who is afraid to put in long hours or work weekends. Brokers work 50 hours a week, on average, but nearly three out of every ten devote 60 or more hours a week to their profession. A full-time saleperson typically spends 49 hours per week on the job, with one-quarter working 60 hours per week or more.

HOURS WORKED PER WEEK IN REAL ESTATE: 1987

(Percentage Distributions)

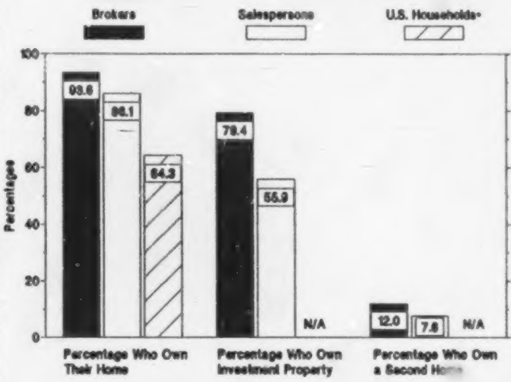


REALTORS® Have a Strong Committment to Homeownership and the Ownership of Real Estate

Real estate professionals practice what they preach. Approximately nine out of every ten brokers and salespersons own the home in which they live. Twelve percent of brokers and slightly fewer salespersons own a second home. More than 79 percent of brokers and just under six out of every ten salespersons own or have an interest in investment real estate which they hold in their personal account.

The rate of real estate ownership is much higher among real estate practitioners than among most American households. A recently released study entitled "Household Wealth and Asset Ownership: 1984" from the Bureau of the Census found that just over 64 percent of all U.S. households own a home. The study also estimates that less than 10 percent of households own rental property and exactly 10 percent own "other" real estate such as second homes for personal use and undeveloped land.

REAL ESTATE HOLDINGS OF REAL ESTATE PRACTITIONERS AND OF U.S. HOUSEHOLDS



N/A: Not Applicable.

* Bureau of the Census, Household Economic Studies, Series H-111

More Detailed Report Also Available

The full report entitled Membership Profile 1987 is available at a price of $12.00 from Catalog Sales, NATIONAL ASSOCIATION OF REALTORS®, P.O. Box 10958, Chicago, Illinois 60610-0958. The full report contains detailed information on the economic, demographic, educational, professional and business backgrounds of real estate brokers and salespersons.

John C. Keaton
Director, Business Studies
Economics & Research Division

January 1988

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1985.0	1986.0	1987.0	1988.0	1989.0
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4445	4521	4587	4638	4700	4779	4859	4957	4010	4235	4483	4744	5094
% Change	6.3	7.0	6.0	4.5	5.4	6.9	6.8	8.4	6.3	5.6	5.8	5.8	7.4
% Change (w/out inflation)	2.5	4.1	2.9	1.0	1.5	2.7	2.6	3.5	3.0	2.9	2.8	2.2	2.9
Consumer Price Inflation (CPI)	4.9	3.9	4.4	4.2	4.3	4.5	4.8	5.0	3.6	1.9	3.7	4.4	4.8
GNP Inflation (GNP Deflator)	3.5	2.8	3.1	3.4	3.9	4.2	4.1	4.7	3.2	2.6	3.0	3.5	4.4
Unemployment Rate - Civilian	6.2	6.0	6.0	6.1	6.3	6.3	6.3	6.2	7.2	7.0	6.2	6.2	6.1
Civilian Employment-Household Basis (millions)	112.2	112.9	113.3	113.6	113.9	114.2	114.6	115.1	107.2	109.6	112.4	114.1	115.8
Percent change	3.4	2.4	1.5	1.2	0.9	1.3	1.3	1.8	2.0	2.3	2.5	1.5	1.5
Manufacturing Capacity Utilization	80.5	81.4	82.0	82.3	82.0	82.0	82.0	82.3	80.1	79.7	80.9	82.1	82.2
Domestic Auto Sales	7.0	8.0	5.8	6.2	6.5	6.9	7.1	7.0	8.2	8.2	6.9	6.7	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.8	20.4	20.1	20.1	20.1	20.1	20.3	20.6	19.7	19.5	20.3	20.1	20.6
Federal Expenditures (NIPA) as % of GNP	23.9	23.4	23.9	23.7	23.5	23.4	23.4	23.2	24.6	24.4	23.8	23.5	22.9
Deficit(NIPA)	-139.2	-137.2	-172.7	-170.9	-158.2	-157.4	-151.8	-125.1	-196.0	-204.7	-154.9	-159.6	-119.4
as % of GNP	3.1	3.0	3.8	3.7	3.4	3.3	3.1	2.5	4.9	4.8	3.5	3.4	2.3
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4718	4542	4542	4221	4309	4301	4404	4383	4254	4717	4659	4309	4548
Percent change -- year ago	1.3	-3.4	-9.4	-12.7	-8.7	-5.3	-3.0	3.8	8.6	10.9	-1.2	-7.5	5.6
Existing Single-family Home Sales (thousands)	3610	3430	3426	3203	3194	3228	3336	3287	3214	3565	3521	3240	3436
Percent change -- year ago	3.8	-4.4	-11.9	-11.5	-11.5	-5.9	-2.6	2.6	12.1	10.9	-1.2	-8.0	-8.0
Housing Starts (thousands)	1612	1610	1582	1536	1518	1507	1526	1593	1742	1819	1650	1522	1620
Percent change -- year ago	-14.2	-8.4	-7.1	-14.4	-5.8	-6.4	-3.5	3.7	-1.4	4.4	-9.3	-7.7	6.5
Single-Family Units	1142	1147	1151	1050	1150	1106	1101	1129	1073	1188	1174	1102	1147
Percent change -- year ago	-6.2	-0.3	-0.7	-16.4	0.7	-3.5	-4.3	7.6	-2.4	10.8	-1.2	-6.1	4.1
Multi-Family Units	470	463	431	486	369	401	425	464	670	631	476	420	474
2-4 Family Units	73	57	53	60	46	50	53	57	93	85	66	52	59
Percent change -- year ago	-9.9	-25.2	-39.4	-24.8	-37.5	-13.4	-1.4	-4.6	-23.3	-8.6	-22.8	-21.1	12.7
5+ Family Units	397	406	378	426	323	352	372	407	576	546	410	368	415
Percent change -- year ago	-31.6	-23.6	-17.2	-7.2	-18.6	-13.4	-1.4	-4.6	5.5	-5.3	-24.9	-10.1	12.7
New Single-family Home Sales (thousands)	674	675	665	637	650	663	687	664	692	745	685	659	690
Percent change -- year ago	-15.1	-1.6	-6.5	-11.9	-3.6	-1.7	3.3	4.2	8.3	7.7	-8.1	-3.7	4.7
Mobile Homes Shipped (thousands)	227	241	241	232	246	244	245	251	283	249	236	242	257
HOME PRICES													
Existing Home Prices - Median ($1000)	85.1	85.5	85.5	86.0	87.5	90.5	92.0	92.8	75.5	80.3	85.1	89.0	93.6
Percent change -- year ago	3.7	5.9	6.6	2.1	2.9	5.9	7.6	7.9	4.3	6.4	6.0	4.6	5.2
New Home Prices - Median ($1000)	103.5	107.2	104.0	106.0	106.6	107.3	106.8	108.0	84.3	92.0	103.0	106.7	111.5
Percent change -- year ago	12.5	14.6	9.4	8.9	3.0	0.1	2.7	1.8	5.5	9.1	12.0	3.6	4.5
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year Fixed Rate Mortgage (FHA Secondary)	10.3	10.7	10.7	10.6	10.5	10.6	10.6	10.3	12.2	9.9	10.1	10.6	10.4
1-year ARM (without buydown)	8.1	8.3	8.2	8.4	8.3	8.2	8.2	8.1	7.6	7.9	8.2	8.3	8.1
Corporate AAA Bond Rate	9.2	9.8	10.1	9.6	9.4	9.5	9.5	9.5	11.4	9.0	9.3	9.5	9.6
Government Bond Rate	8.5	9.1	9.1	8.5	8.3	8.4	8.5	8.5	10.8	7.8	8.5	8.4	8.7
Short-Term Interest Rates													
Federal Funds Rate	6.7	6.8	6.9	6.5	6.4	6.6	6.7	6.8	8.1	6.8	6.6	6.5	7.0
3-month T-Bill Rate	5.7	6.0	5.8	5.4	5.3	5.4	5.5	5.6	7.5	6.0	5.8	5.4	5.7
Prime Rate	8.0	8.4	8.7	8.4	8.1	7.7	7.6	7.6	9.9	8.3	8.2	7.9	7.9
Discount Rate	5.5	5.7	5.8	5.5	5.5	5.5	5.5	5.5	7.7	6.3	5.6	5.5	5.5
Money Supply (M1)(% change)	6.5	0.0	8.5	7.8	7.9	7.3	6.4	6.9	9.1	13.3	11.5	6.7	6.6
Value of the U.S. Dollar (Trade-Weighted Avg.)	97.0	98.7	93.0	89.8	88.6	87.6	86.4	86.2	143.2	112.3	97.1	88.1	85.6
Percent change	-11.1	7.2	-21.1	-12.9	-5.3	-4.7	-5.1	-1.0	3.5	-21.6	-13.5	-9.3	-2.9

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE
OUTLOOK

Vol. 1, No. 2 *February 1988*

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Fourth quarter real (inflation-adjusted) GNP growth was reported at an annual rate of 4.2 percent. The fourth quarter GNP advance was almost exclusively based upon inventory accumulation and net export growth. In contrast, the 4.3 percent annual rate of third quarter real GNP growth was due largely to consumer spending, net export growth and equipment spending by business.
- Real GNP growth in the first quarter of 1988 is expected to slow to an annual rate of 1.0 percent as businesses work off their uncomfortably high stocks of inventories. Weak consumer demand will complicate the effort to sell off inventories, placing much of the burden of first quarter growth on the export sector. In 1988, real GNP growth is expected to slow to a rate of 2.3 percent on a year-over-year basis.
- Consumer price inflation in 1987 accelerated moderately to 3.7 percent when measured on a year-over-year basis. Consumer prices are in no danger of rising out of control in 1988, given the current forecast of slow growth. Consumer prices are expected to rise 4.1 percent in 1988 on a year-over-year basis.
- Short-term interest rates are expected to fall slightly in the first half of 1988, as the monetary authority works to keep the economy from slipping into a recession. Long-term interest rates could also benefit from the slow growth expected in the first two quarters of 1988. A mild bond market rally could help push mortgage interest rates down in the first half, before renewed economic growth in the second half contributes to some firming in interest rates.
- Sales of existing single-family homes reached 3.52 million units in 1987, only 1.3 percent below the 1986 rate of 3.57 million units. Existing single-family homes are expected to be sold at an annual rate of 3.19 million units in the first half of 1988, before strengthening to an annual rate of 3.26 million units in the second half.

IN THIS ISSUE

- **Economic Commentary: THE CRUELLEST MONTH, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Secondary Market Outlook, by Mary A. Fruscello**
- **Update on the FY1988 Budget Process, by Frederick E. Flick**
- **Special Topic: Foreign Investment in U.S. Real Estate**

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THE CRUELLEST MONTH:

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

February made me shiver
With every paper I'd deliver
Bad news on the doorstep;
I couldn't take one more step
-- Don McLean, "American Pie"

Eliot was wrong; February is the cruellest month. Just when you've had enough of winter -- enough cold, enough snow, enough darkness --along comes the coldest, snowiest and darkest of months. Along comes the shortest month that seems to last for thirty-five or thirty-six days instead of twenty-eight or twenty-nine. Along comes the real winter. February is a time without a saving grace -- no holiday merriment, no promise yet of spring and sun and warmth. It is a time that must be endured against the (almost) certain prospect that better days will come. Look around: everyone may be wishin' and hopin', but they're all just trudgin' and copin'.

The economy also has a case of the Februaries: consumer spending survived through the holidays, but with an increase (0.7 percent) that was not quite up to snuff; January auto sales were well above 1987, but that was a disappointing month; the trade figures are significantly better, but it could be a seasonal fluke; GNP will grow by over two percent this year but at only half that rate in the first six months. In other words, the news is not bad, but it's not good enough. We have reached an unfortunate intersection. Housing and consumer spending, which had paced this expansion, have fallen back into the pack and no new leader has emerged. In fact, during the coming year, we will see exports stimulate industrial production and lead the economy. But for now, we appear to be drifting, uncertain because of financial markets and worried about the international economy. In short, this is a time when neither optimism nor pessimism is clearly warranted.

For housing, this is a time to catch a second wind. During the past two years (1986 and 1987), we sold over 7 million existing homes. Of the past ten years, these were the two best. Additionally, housing starts over the last 24 months have been very strong for the fifth and sixth years of a housing expansion. Right now, the rate of starts is 80 percent above the low point that began the expansion. No other post-war cycle was as high at this age; no other cycle was still in expansion at this age. In short, we have come through a period of housing intensity that must inevitably yield to a more gentle pace.

Accordingly, this year will not be as good a year for housing as was 1987. Right now, we expect existing home sales to decline to 3.22 million units (an 8 percent decline), new home sales to total 660,000 (down 3 percent) and starts to fall to 1.54 million (from 1.64 in 1987). The multifamily sector in particular will be weak during 1988. Currently, we can absorb 400,000 multifamily units through existing demand. But the sector as a whole is overbuilt, suggesting that multifamily construction must fall well below 400,000 units if the market is to achieve some semblance of equilibrium.

Like the economy, housing will look much better the farther we move from the dread February. Because interest rates will rise, and then fall (election economics kick in about May), housing activity will grow through the year and be strongest in the second half. The structure of the population is a real plus for the housing sector and the demand for homeownership will be strong. As 1988 matures, and rates fall, this demand will assert itself. Moreover, house price appreciation will moderate during 1988, with both existing and new home prices rising by about 4 1/2 percent.

The wild card in this whole picture is still the dollar. Intervention by the world's central bankers, regardless how massive, cannot maintain the dollar at value levels unjustified by economic fundamentals. We ought to see a continuation of the good trade figures unveiled in January. On the optimistic side, a $30-40 billion reduction in the trade deficit could occur in 1988. But if there is no improvement in the deficit, the dollar could go into free fall and set off the stagflationary forces that dogged this economy in the late 70's.

So, even the international picture has a February kind of look. We know the days are getting longer, we know spring is coming, but we have no hard, definitive evidence that our hopes and assumptions are indeed reality. In short, we are in a month with little redeeming value. Oh well -- at least I've kept my new year's resolution: I have not yet eaten anything with suction cups, even if it's raw.

Outlook for the Economy and Real Estate

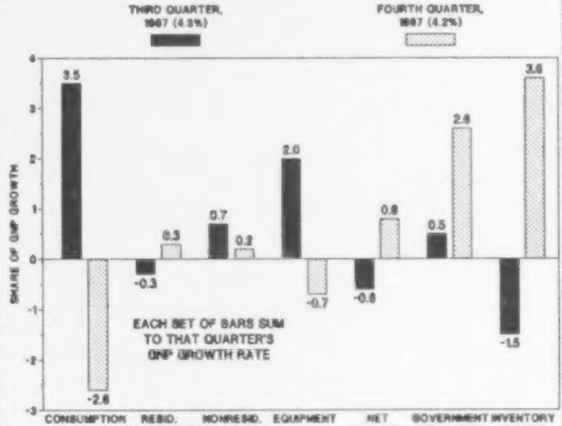
According to most economic indicators, the longest peacetime expansion on record has yet to stumble, although there are several reasons to be cautious that the end to the boom may indeed be in sight. At the time this issue went to press, the government had just released its estimate of the fourth quarter annual rate of real (inflation-adjusted) GNP growth. This preliminary estimate showed that real GNP growth reached an annual rate of 4.2 percent in the final quarter of 1987, virtually identical to the 4.3 percent annual rate of the third quarter. However, no two identical growth rates may have ever been more different (see below). In 1987, real GNP rose 2.9 percent when measured on a year-over-year basis, and by 3.8 percent from the fourth quarter of 1986 to the fourth quarter of 1987.

Accompanying the GNP report was news that the GNP deflator (a broad measure of inflation) rose at an annual rate of only 2.7 percent. While the rate was only marginally below the 2.8 percent rate of the third quarter, the report came at a time when inflation worries were on the rise. Fear of potentially harmful high rates of inflation were touched off by a sharp decline in the value of the U.S. dollar in December, and expectations that import prices were on the verge of pushing up domestic consumer prices. However, the data on consumer prices does not seem to bear this out. When measured from December 1986 to December 1987, consumer prices rose 4.4 percent. While this rate was more than double the 1986 pace, it is well within the limits experienced in past economic expansions. In addition, the January announcement of a large decline in the monthly merchandise trade deficit for November (due to strong export growth) has eased the run on the dollar.

Changing Composition of GNP Growth

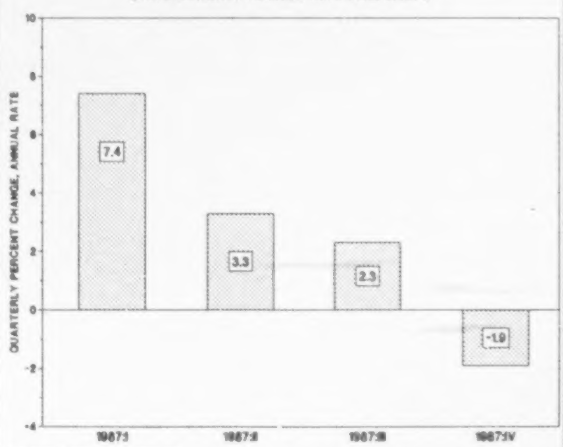
The composition of these two estimates paint two strikingly different pictures of the economy (see Graph 1). The third quarter rate of expansion came on the strength of consumer spending, export growth, and related equipment purchases by manufacturers in the midst of re-tooling efforts to respond to the export boom. These advances in final sales were offset to a small degree by a decline in inventory investment in the third quarter. Disaggregating the fourth quarter data in the same manner shows that fourth quarter final sales were almost flat, as declines in consumer spending offset gains in other components. If the annual fourth quarter purchases of the government's Commodity Credit Corporation are netted out from the GNP data, then final sales actually declined in the fourth quarter. In contrast, inventory investment accounted for virtually all of the fourth quarter gain. Inventory accumulation at the manufacturing level is explained by faster growth in export demand. But inventory accumulation at the wholesale and retail levels will have to be sold off in 1988, setting the stage for production cutbacks in the first quarter.

A closer look at the trend in consumer spending during 1987 better explains the sudden transformation in the composition of GNP growth. The fall-off in consumer spending was evident in the mixed performance of retail sales in the fourth quarter. Retail sales ended the quarter on a positive note with a 0.7 percent advance in December. However, one month does not a quarter make, as a large decline in October and a negligible change in November paced fourth quarter retail sales to a slower rate than in the previous quarter. Graph 2 shows the steady decline in retail sales (excluding the auto component) throughout 1987, indicating that the present weakness in consumption is not due wholly to the October stock market crash.



GRAPH 1: A SUDDEN CHANGE IN THE COMPOSITION OF REAL GNP GROWTH

SOURCE: Dept. of Commerce, Bureau of Economic Analysis



GRAPH 2: RETAIL SALES SLUMP
(DATA EXCLUDES VOLATILE AUTO COMPONENT)

SOURCE: DEPT. OF COMMERCE

THE ECONOMIC OUTLOOK

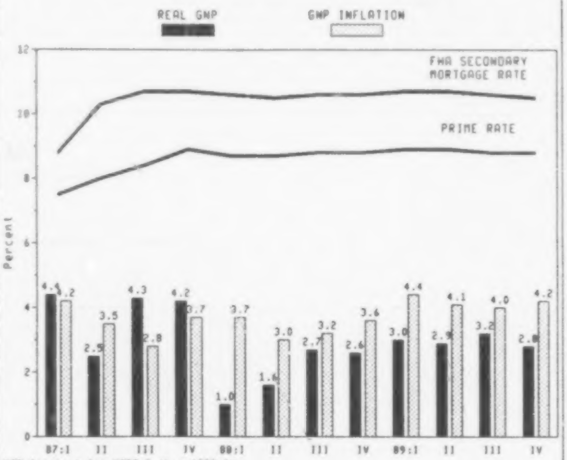
The fourth quarter GNP report implies that the economy will continue to move forward, but at a slow rate in the first quarter of 1988 (see Graph 3). The reasoning for this goes as follows. The buildup in inventories in the wholesale and retail trade industries will undoubtably force a slowdown in production during the first quarter. All indications are that the American consumer will spend the quarter buying back his debt and not new products. Offsetting this (and to what degree remains the question) will be continued growth in exports and renewed equipment spending by export-related industries. Inflation should remain under control given slack domestic demand and debt-conscious consumers who will likely curb their appetite for increasingly expensive imported goods. Both long- and short-term interest rates could slide back a bit in the first half of 1988, if reports of a slow economy ring true. The current forecast for first quarter real GNP growth remains unchanged from the January forecast of 1.0 percent. For the year, real GNP is expected to rise 2.3 percent above its 1987 level.

In apparent contradiction to this forecast for slower growth, industrial production has been rising steadily (Graph 4). Since the latter half of 1986, industrial production has mounted a comeback, rising 5.2 percent in 1987 alone. However, manufacturers reported using 82.1 percent of their capacity in December, meaning that less and less capacity remains to produce goods for export. For capacity-constrained industries like chemicals and paper, expanding their existing capacity to meet higher export demand is critical. However, many businesses have just emerged from difficult layoffs and plant closings, and are understandably reluctant to expand their capacity this early in an export boom. The upshot is that while industrial production needs to remain high to help avoid a stagnant economy, capacity limits are being reached in many industries which could lessen the expected boost to the economy from an expansion in exports.

Monetary Policy and Interest Rates

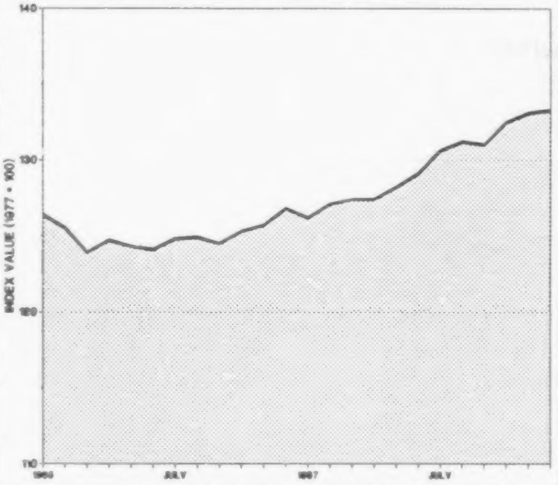
Faced with uncertain strength in the economy and international investors alternatively pleased and displeased with holding dollars, the Federal Reserve has a difficult task in carving out an effective monetary policy in 1988. At the time of the stock market crash, the Fed wisely pumped liquidity into the economy to meet the demand for cash and equivalents. Satisfied that the economy was not on the brink of collapse, the Fed appears to have since tightened up on monetary policy which has stabilized interest rates. The fourth quarter GNP report could prod the Fed to ease up on monetary policy so that the economy continues to grow through the first half of 1988. To that end, this forecast retains the assumption of the January forecast that the Fed nudges short-term rates down in the first half of 1988 (Graph 5). Assuming economic growth heats up in the second half of the year, the Fed is assumed to tolerate only a slight rise in rates in the face of the November elections.

GRAPH 3: THE ECONOMIC OUTLOOK

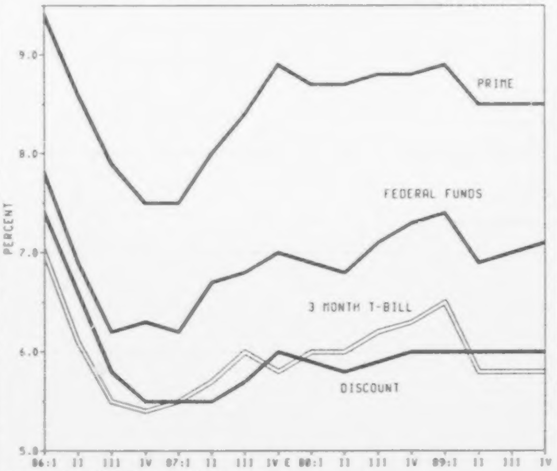


WAR forecast for 1988:I thru 1989:IV.

GRAPH 4: INDUSTRIAL PRODUCTION HEATS UP



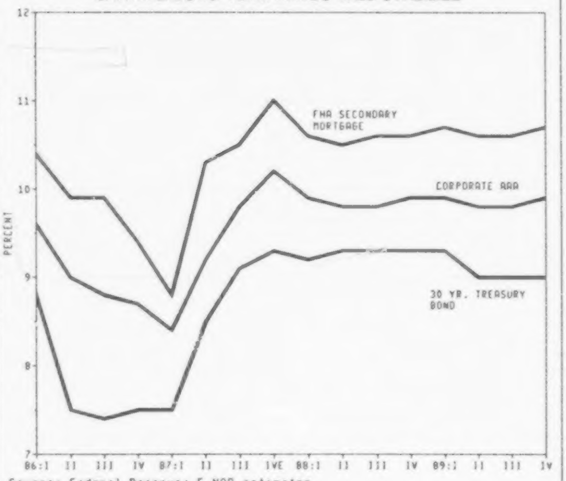
GRAPH 5: SHORT-TERM RATES SOFTEN BRIEFLY



Source: Federal Reserve; E WAR estimates.

Long-term interest rates have fluctuated in a narrow band in recent months. The fourth quarter GNP report could likely touch off a bond market rally that would move long-term rates out of this tight band. Such a rally could keep long-term rates down through the first half of 1988 (Graph 6). The potential exists for long-term rates to remain at these reduced levels through the second half of 1988 as well. However, the latter half of 1988 poses some risk for a slight rise in long-term rates if economic growth is buoyed by strong export growth and the return of the American consumer. In 1987, the interest rate on a 30-year fixed rate mortgage sold in the secondary market was 10.0 percent. However, the year just finished had its ups and downs with respect to long-term rates, ranging from 8.8 percent in the first quarter to 11.0 percent in the final period. More stability is expected in 1988, with rates not expected to test the lows of the first quarter of 1987. Mortgage interest rates are expected to average above 10 percent throughout 1988, despite the slow growth environment. This is partly due to our dependence on foreign capital to satisfy our domestic capital needs.

GRAPH 6: LONG-TERM RATES WILL STABILIZE



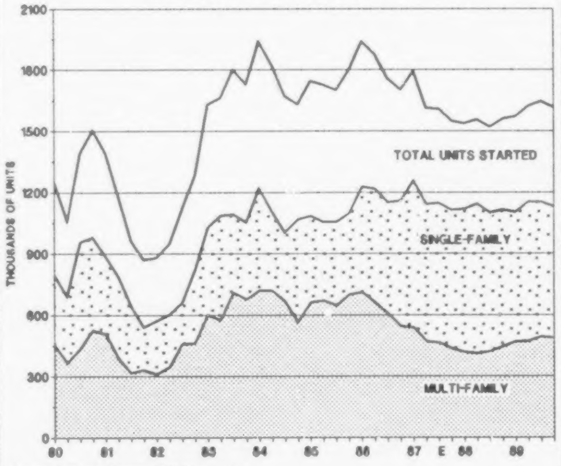
Source: Federal Reserve; E NAR estimates

REAL ESTATE MARKETS

Housing Starts

Total single-family housing starts declined to an annual rate of 1.374 million units in December, a 16 percent decline from the November annual rate of 1.639 million units. Compared to December 1986, total housing starts were down by 24.2 percent. Single-family homes were started at an annual rate of 1.023 million units in December, 7.8 percent below the November annual rate of 1.11 million units. Multi-family units accounted for more of the decline, falling to a December annual rate of 351 thousand units, down 33.7 percent from the November annual rate of 529 thousand units. Total starts fell in all regions of the country, with the West experiencing the largest drop: more than 26 percent. In 1988, housing starts are expected to continue on this downward trend, falling 6 percent in 1988 (Graph 7). Single-family starts could total 1.12 million units in 1988, almost unchanged from 1987.

GRAPH 7: HOUSING STARTS

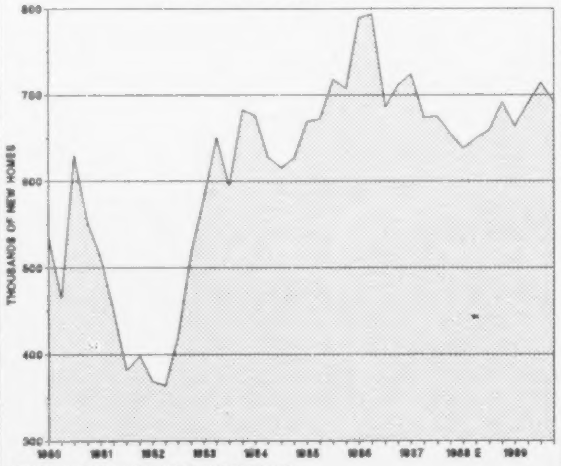


Source: Bureau of Census; E NAR estimates.

New Home Sales

The annual rate of new single-family home sales in November fell to an annual rate of 664 thousand units, 1.2 percent below the revised October annual rate of 672 thousand units. The eleven month average for new home sales through 1987 is 685 thousand units, three percent above the November annual rate. For comparison, in 1986 total single-family home sales reached 750 thousand units. In 1988, new home sales are expected to reach 660 thousand units, a 3.3 percent decline from the 1987 expected total of 682 thousand units (Graph 8). Weakness in the economy and very high prices will discourage some consumers from buying a new home, leading them to consider existing homes as an affordable alternative.

GRAPH 8: NEW HOME SALES



SOURCE: BUREAU OF CENSUS; E - NAR FORECAST.

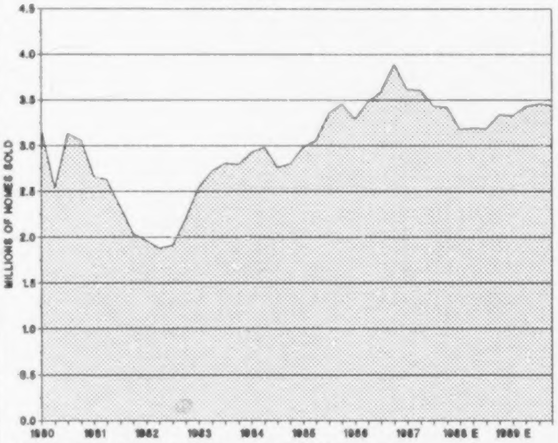
Existing Home Sales

Existing single-family homes were sold at an annual rate of 3.28 million units in December, a 3.8 percent decline from the November annual rate of 3.41 million units. For the year, existing home sales totaled 3.52 million units, just 1.3 percent below the 1986 total of 3.565 million units (Graph 9).

All regions registered a drop in existing home sales rates during December. Existing home sales in the Midwest region declined 8 percent to an annual rate of 810 thousand units, sales in the Northeast fell 4.5 percent to an annual rate of 630,000 units, the West was off 1.7 percent to a 580,000 unit pace, and the South edged down by 1.6 percent to a 1.26 million unit pace. These declines do not so much foreshadow a large scale retreat as they suggest the housing market is, after two very strong years, taking a breather of sorts. During 1986 and 1987, more than 7 million existing homes were sold, by far the strongest two year sequence of the 1980's.

In 1988, sales of existing single-family homes are expected to decline 8.4 percent to 3.224 million units. Strength in existing home sales is expected to build throughout the year. A sluggish economy in the first half will hold existing home sales to an annual rate of about 3.19 million units over the first six months. As economic growth returns in the second half, existing home sales are expected to increase to a 3.26 million unit rate during the second six months.

GRAPH 9: EXISTING SINGLE-FAMILY HOME SALES
(Seasonally Adjusted Annual Rates)



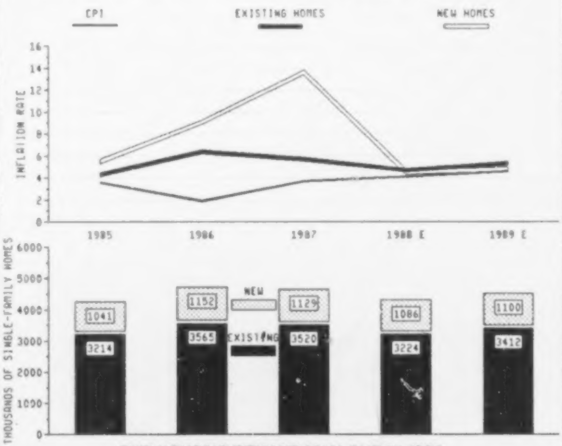
SOURCE: NAR ECONOMICS & RESEARCH, E - NAR FORECASTING & POLICY

Home Prices

The value of both existing and new homes continued to appreciate in real terms during 1987 (Graph 10). For the year, the median existing home price rose to $84,900, a 5.7 percent increase over the 1986 median existing home price of $80,300. Through the eleven months of 1987 for which there is data, the median new home price rose to $104,200 in 1987, a 13.3 percent gain over the 1986 median new home price of $92,000. Since the interest rate rise in the Spring of 1987, new home prices have skyrocketed. This peculiar relationship seems to be reflecting the fact that those persons still capable of purchasing a new home after the interest rate rise of 1987 tend to be higher earning individuals who are purchasing larger homes. Therefore, the sample of new homes used in the statistic is being skewed toward the more expensive end of the new home spectrum.

In 1988, both existing and new homes will continue to appreciate in real terms, but new home prices are expected to appreciate at a markedly slower rate than their 1987 rise. The median existing home price should rise by about 4.7 percent in 1988 to about $88,900. The median new home price is expected to rise by about the same amount, 4.5 percent, and reach an annual average of $109,200.

GRAPH 10: HOMES CONTINUE TO APPRECIATE IN REAL TERMS...



BUT HOUSING DEMAND MAY SLIP IN 1988

NOTE: New home total equals 97% of single-family starts.

Sean A. Burns
Research Economist
Forecasting & Policy Analysis Division

Secondary Market Outlook

by
Mary A. Fruscello
Division Vice President
Real Estate Finance

For the mortgage markets, 1987 was in many respects the best of times and the worst of times. In retrospect, that twelve month period was a microcosm of much of both the good and bad that the market can experience. Unfortunately, the outlook for 1988 appears to promise more of the same "blessing" of interesting times.

The record loan demand of the early part of the year that delayed processing of loan applications, frustrating borrowers and delaying closings, eventually slacked off. Much to their surprise, lenders who were still staffing up heavily in the spring found volume dropping substantially by the third quarter. The heavy demand for refinancing was over, and when the dust settled, applications for purchase money mortgages were not strong. By early 1988, the mortgage pipeline overflow of May had become the trickle of January. Mortgage bankers who were desperately raiding competitors for experienced personnel nine months ago have instituted extensive layoffs.

The drop in loan activity is reflected in the secondary market. Issuance of pass-through mortgage backed securities (Fannie Mae MBSs, Freddie Mac PCs and Ginnie Maes) has declined steadily since summer, and sharply since October. Salomon Brothers estimates November issues at $10.6 billion, less than half the $22.6 billion issued in July. Freddie Mac reports commitment volume through its open window programs (i.e., programs under which it issues commitments to buy loans directly from lenders) has dropped from approximately $760 million in June to nearly $60 million in November.

Of course, a key reason for the drop in mortgage backed security volume is the dramatic change in product mix since summer. ARMs have become the mortgage of preference for an increasing number of homebuyers. As a result, the supply of fixed rate mortgages has declined, reducing the "raw material" for the bulk of mortgage backed pass-through trading.

For the most part, ARMS are being held in portfolio by thrift originators or sold by mortgage bankers directly, rather than in security form. Both Fannie Mae and Freddie Mac have stepped up their efforts to increase investor interest in ARMs securities, emphasizing investment quality and reduced servicing problems compared to direct investment in ARM mortgages.

The market's response to the agencies' attempts to stir up enthusiasm for these securities has been underwhelming. The dearth of significant trading volume continues, and pricing is not favorable compared to direct sale of the loans, even through the agencies' direct purchase programs.

One area where there has been some activity in ARMs securities has been in privately negotiated transactions with Fannie Mae and Freddie Mac. Some large lenders have obtained agreements to convert huge blocks of adjustable mortgages to security form, for subsequent sale in the secondary market. Many of these loans are tied to the Federal Home Loan Bank Board 11th District Cost of Funds index, which has become popular with investors because it tends to lag the market when rates decline. Securities backed by these loans have had some trading activity.

There is also some indication that these negotiated transactions are being structured to permit greater lender flexibility in underwriting, while maintaining eligibility for securitization. This may be good news for homebuyers. Underlying security structure, with guarantees as to loan quality, may be used by lenders to offer more attractive qualifying terms to borrowers. Lenders have great motivation to do so, as they attempt to improve their share of what many project will be a smaller volume market this year.

Ironically, the reduced supply of all mortgage backed securities has had a dampening effect on yields. This softening has been reflected not only in the primary market, as rates have come off their pre-October levels, but also in the December prepayment rates for securities, which surprised analysts by increasing for almost all coupons. Rates may come off even more with the unexpected low trade deficit announced in January.

There is great uncertainty in the secondary market, however, about the long term outlook for mortgage rates. Although higher prepayments and low volume may indicate continued downward pressure, analysis of recent security pricing shows some signs that investors expect higher rates in the future. For example, securities prices have risen in recent weeks, as rates have declined. But changes in pricing on discount (below par) securities and premium (above par) securities have been unequal--recent price increases have been as much as one point greater for the latter. This change in the relative pricing of these securities suggests that investors in above market coupon securities expect prepayments to slow in the future, making premium securities a relatively more attractive investment. The most likely reason for a prepayment slowdown is higher mortgage interest rates.

Certainly high on the list of mixed blessings from last year are the disturbing disruptions in liquidity for mortgage backed securities. Thus, the drop in security trading volume, regardless of the reasons, and even the corresponding decline in mortgage rates, is ill-timed. Some investment banking firms had already begun to trim their mortgage securities departments, in the aftermath of substantial losses in the spring and fall. Although major dealers remain active in the market, retrenchment in trading at a time when volume is thin poses a potential threat to liquidity, which has been the greatest benefit of securities trading to mortgage lenders and borrowers.

Clearly there is some rethinking of the role of mortgage backed securities, until recently a principal source of profits for several investment banking houses, and the resources that might in future be devoted to improving the marketability of mortgage products.

This is unwelcome news for borrowers. There are fewer portfolio investors available to buy ARMs than the investment base the capital markets provide. If and when they have their fill of ARM product, there may be little incentive to price loans attractively. A market moving towards a less liquid instrument, in conjunction with reduced efforts to address liquidity problems, could present problems in the long run for homebuyers seeking financing at reasonable costs.

UPDATE ON THE FY 1988 BUDGET PROCESS

by
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Introduction

In last month's issue of the Real Estate Outlook (Taxing and Spending Washington Style: A Closing view of the FY 1988 Budget Process) we tracked the process to the point where a joint House-Senate Conference Committee was meeting in the middle of December to put together a final package of taxing and spending increases that both Houses could agree upon and that the President could support.

The joint package which Congress was considering involved two bills: an omnibus reconciliation measure which wrapped annual appropriation bills for 13 separate government departments (none of which had been separately passed this year) into a single measure; and a deficit-reduction package of tax increases, sales of federal assets, and cuts in some parts of otherwise non-appropriated programs such as Medicaid, Medicare, and farm subsidies.

The budget bill totalled $598 billion for programs/operations dependent on annual spending bills; however, it is important to note that total Federal expenditures for FY 1988 should be about $1 trillion as they will include entitlement programs such as Social Security, Medicare, and Medicaid. Since October 1 (the beginning of FY 1988), the government had been operating under four short-term continuing resolutions, providing "on-going" funding at last year's levels.

The President signed the two bills on Dec. 22. The deficit reduction bill is expected to reduce the federal deficit by $17.6 billion in 1988. The two measures are projected to reduce the budget deficit by $33.2 billion in FY 1988 and $79 billion over the next two years. These figures exceed the targets of the November 20 deficit reduction agreement. The President was critical of the process, especially the wrapping of the 13 unpassed appropriation bills into the single omnibus spending measure. Furthermore, because the government had been running on several consecutive continuing resolutions at FY 1987 spending levels if the President had not signed the bills, the government would have shut-down, at least until another short term extension at 1987 levels was passed. Nevertheless, everyone was happy the budget had finally been passed and the President offered his congratulations by telephone to the leaders of Congress.

Policy Issues Involved in the Budget

The budget process of the last two years has involved an end of the year "wrapping-up" of individual appropriations bills into a single omnibus bill (without prior completion and Presidential signature of individual agency/department budget bills). Furthermore, because the budgets of individual government agencies embody much of the program impact and policy direction of individual agencies/departments, the debate is not simply over spending and taxing numbers, but also over policy issues.

One concern was the Administration's objection to reinstatement of the Fairness Doctrine in one of the bills. Also, the Administration had wanted larger cuts in Medicare, Postal Service spending, and larger proposed asset sales. However, for accepting promises to make further deficit reductions in these areas next year, it secured exclusion of the Fairness Doctrine from the package. However, the most important policy debate centered on providing further non-lethal aid to the Nicaraguan contras. Under a compromise that was worked out, the contras would receive $8.1 million through the end of February and Congress would vote again on additional aid in early February.

Provisions of the Spending Bill

The $598 billion appropriations measure includes the following major provisions:

- Non-lethal funding of $8.1 million for the Nicaraguan contra rebels through the end of February, allowing shipment of previously authorized military aid until Jan. 12. It also guarantees House and Senate votes on Feb. 3 and 4 on any new Reagan administration request for further military aid.
- Spending cuts in government programs of $15.6 billion, including $5 billion in military and $2.6 billion in domestic discretionary programs covering such items as education and law enforcement. The bill includes $3.9 billion for the Strategic Defense Initiative; the President requested $5.7 billion.
- The administration can sell up to 70 Stinger antiaircraft missiles to Bahrain, but that nation would have to return any unused missiles within 18 months.
- The administration can resume sending $480 million in foreign aid to Pakistan if it waives current law barring aid to nations that have a nuclear weapons capability but do not submit to international inspection.
- Most federal workers receive a 2 percent pay increase, except members of Congress, federal judges and senior executives.
- Delays by eight months the imposition of financial penalties against metropolitan areas that fail to meet pollution standards for ozone and carbon monoxide under the Clean Air Act.
- Provides $905 million for AIDS research, nearly double last year's amount.

- Allows 20 states to increase the speed limit to 65 mph on rural four-lane highways for four years. Currently states can raise the limit only on rural interstate highways.

The second bill passed by Congress and signed by the President involved two components: 1) tax increases to raise revenue through increases on corporations and well-off individuals; 2) and, a package of asset sales and cuts in non-appropriated programs to reduce the deficit by $17.6 billion. The tax component includes the following provisions:

- Extend the 3 percent tax on telephone service, which otherwise would have expired at the end of this year.
- Limit the deduction for interest on a home mortgage to loans of $1 million or less, for up to two residences.
- Limit the deduction for other loans (i.e., home equity/second mortgages) using a home as security to amounts of $100,000.
- Individuals who pay taxes on an estimated basis can pay only 80 percent of their ultimate bill in advance rather than 90 percent as current law requires.
- Freeze the top rate on estate and gift taxes at the current 55 percent for five years, rather than allowing it to fall to 50 percent next year.
- Require inactive-duty military reservists, some agricultural workers and children who work for their parents to pay Social Security taxes.
- Deny the tax credit for child care for the expenses of sending a child to overnight camp.
- Extend a 0.2 percent surtax on the unemployment-insurance tax paid by employers for three years.
- Close an estate-tax loophole opened by the 1986 tax law that provided advantages for investing in employee stock ownership plans (ESOP).
- Accelerate the collection of estimated taxes paid by corporations.
- Increase the base contributions companies make to the Pension Benefit Guaranty Corp. from $8.50 per employee to $16, with additional contributions of up to $34 possible for companies with underfunded pension plans.
- Raise the railroad-retirement tax and permit the general fund to subsidize the railroad fund for one year.
- Impose a 50 percent tax on stock gains by corporate "raiders" incurred when they try to take over a company.
- Require defense and construction contractors to pay taxes on at least 70 percent of their income each year rather than the current 40 percent.
- Deny use of the foreign tax credit to income American companies earn on operations in South Africa.

The second component of the reconciliation bill provided the following cuts:

- Cut the growth of Medicare by $2.1 billion in 1988 and $3.6 billion in 1989. About $550 million of the 1988 savings would come from extending the automatic spending cuts through next April for most Medicare programs. However, spending for Medicaid will be increased by $44 million in 1988 and $633 million over three years.
- Allows retiring federal workers in fiscal 1988 and 1989 to take only 60 percent of their benefits in the year they retire, rather than the entire lump sum that they are now allowed. They could take the remaining 40 percent the following year.
- Postpone some future U.S. Postal Service construction and require the USPS to compensate the general fund for some health-benefit costs for retirees. The Postal Service would not be allowed to raise rates to cover the higher costs.
- The Energy Department will select Yucca Mountain, Nevada as the site of the nation's first and only high-level nuclear waste dump.
- Reduce agricultural target prices and loan rates for major commodities.

Sources: The Washington Post, "Spending, Tax Bills Signed by President," by L. Cannon and A. Sewardson, p. A-1, A-6; and "Provisions of the Bills," p. A-6, December 23, 1987.

Principal Provisions of The New Tax Law

The tax provisions are expected to raise $9 billion of additional revenue in fiscal 1988 and $14 billion in 1987. Increases in corporate estimated tax payments are expected to raise $1.7 billion, but only $850 million was considered in meeting the 1988 target. A number of proposals considered in the House and Senate were dropped by the conferees:

- Technical corrections to the Tax Reform Act of 1986.
- The increase in the corporate minimum tax preference item from 50 percent to 100 percent of book-tax difference.
- Non-deductibility of interest on borrowing for corporateacquisitions.
- Limiting tax deferral for like-kind exchanges of real property.
- A de minimis exception to the look-back method under the long-term contract rules.
- Amortization of customer base intangibles.
- A parent's election to claim unearned income of dependent on return of parent.
- Elimination of the dividends-received deduction on stock that has non-stock characteristics.
- Limitation on consolidated return passthrough.
- Mandatory Section 338 election for hostile tender offers.
- Changes in tax treatment of mergers and acquisitions of bankrupt corporations.
- Repeal of exceptions to below-market loan rules for continuing care facilities.
- Current taxation of market discount on bonds.
- Repeal of state death tax credit under the estate and gift tax.

- Minority discounts under the special valuation rules.
- Limitation of the taxable benefit option under cafeteria plans.
- Non-deductibility of interest on debt used to purchase or carry tax-exempt installment obligations.
- Collection of tax from partnerships.
- The "runaway plant" proposal whereby certain imported property income of a CFC would be denied deferral and subject to a separate foreign tax credit limitation.
- The change in tax treatment of certain insurance syndicates.
- The change in tax treatment of net investment income of trade associations.
- Modifications to low-income housing credit.
- Repeal of the ceiling on income subject to the Medicare tax.
- Modification of the COBRA health care continuation coverage penalty.

The provision that would have had the heaviest impact on the real estate industry is the loss of tax liability deferral on like-kind exchange capital gains. Because this item was salvaged, 1988 could become a big year for this type of transaction. However, the $1 million cap on principal for interest deductibility and part of the restrictions on home equity loan interest ($100,000 married and $60,000 for singles) were passed. The provision that would have excluded boats and mobile homes as second residences was dropped.

Source: Coopers and Lybrand, "An Overview of the Principal Provisions of the 1987 Tax Act," Tax Notes January 4, 1988, pp. 67-75.

Epilogue

The March issue of the Outlook will provide a more detailed presentation of the major real estate-related provisions of the new tax law and, if space permits, an overview of the President's proposed budget for FY 1989 (beginning October 1, 1988) which will be sent to Congress and released to the public on or about February 15.

Of course, preliminary versions of this document, currently being finalized, have already been leaked to the press causing some concerns over proposed "cuts" and "shifts." Thus, although we are just a little over a month past the enactment of the FY 1988 budget, the debate on the dollars and issues of the FY 1989 budget has already began. In Washington, budgeting and the accompanying political machinations are an on-going feature of work and life in the shining city on the hill.

SPECIAL TOPIC: FOREIGN INVESTMENT IN U.S. REAL ESTATE

The NATIONAL ASSOCIATION OF REALTORS® Forecasting & Policy Analysis Division and the International Affairs Division recently released a joint project entitled "Foreign Investment in U.S. Real Estate: The New International Landlords." The purpose of the report was to promote a better understanding of the role foreign investment plays in the United States economy, in light of the increasingly integrated world economy in which we operate. Its particular importance to U.S. real estate is examined through a study of foreign investment behavior in three U.S. cities: Los Angeles, Washington, D.C., and Chicago.

The integration of the world's economies and financial markets, spurred on by technological advances in information processing has greatly heightened awareness of worldwide investment alternatives. Huge international flows of capital have signaled the approval of foreign investors to this expanded universe of investment options. Given the freedom to choose, foreign investors have invested huge sums in the U.S. economy, through either portfolio investments or direct investments in U.S. industries, including real estate.

The financial strength to capitalize on these worldwide opportunities has in the past lain with American and European institutional investors. Today, large trade surpluses between Japan and its trading partners coupled with a stronger yen in dollar terms has refocused investor activity from Western Europe to Japan.

Reasons given by these foreign investors include the higher rate of return available in the U.S.; a large and diverse market offering investments ranging from U.S. Treasury bonds to regional shopping malls; a deep market that promises an abundance of buyers for almost any investment held for future disposition; a stable government; a highly skilled labor force; a less onerous tax system: in sum, the largest and most unfettered economy the world has yet known. A few statistics illustrate how these foreign investors are expected to choose.

Foreign investors will send an estimated $150 billion into the U.S. economy in 1988, of which 75 percent (or about $110 billion) will be directed into portfolio investments, like U.S. Treasury securities or corporate bonds. Currently, Japanese investors account for the largest share of this investment, contributing 25 cents of every dollar of foreign portfolio investment in the U.S. The remaining 25 percent ($40 billion) will be invested directly into U.S. industries, including purchases of U.S. real estate, which could total $10 billion in 1988.

Progress in the sale of U.S. housing-related assets to foreign investors is an important part of this portfolio investment inflow because proceeds can be used by U.S. thrifts to expand housing activity in their region. U.S. thrifts have raised nearly $10 billion in overseas capital markets, and foreign investors have become increasingly receptive to their offerings as they have gained a better understanding of these securities. During 1987, these and other portfolio investments expanded the pool of investment funds available to the U.S. housing industry, contributing to an additional 800,000 sales of 1-4 family homes. The value of these additional home sales due to foreign financing is estimated to be $68 billion.

The value of foreign direct investments in U.S. industry rose by $24.7 billion to a total year-end position of $209 billion. Government experts estimate that this figure translates into a total asset value of more than $1 trillion.

A study commissioned by the NAR International Affairs Division and executed by the Massachusetts Institute of Technology/Center for Real Estate Development analyzed foreign investment in U.S. real estate in Los Angeles, Washington, D.C., and Chicago. This research sought to determine whether there were characteristic differences between foreign investors and their American counterparts. Differences in investor preferences were found and documented. Also, the amount of foreign investor involvement in each of the three cities was found to vary substantially and for different reasons. Here are the findings of the study.

The data derived from each of the three city analyses confirms the bi-coastal nature of foreign investment, and that foreign investors have clear preferences between these coastal cities. More than half (51.6 percent) of the 12.1 million square feet of office space in the Los Angeles central business district (CBD) is foreign-owned. Foreign ownership of the Washington, D.C. CBD is 25 percent of 53 million square feet. Information on foreign- owned office property in Chicago was difficult to develop, but approximately 7 percent of the total suburban and CBD market, and as high as 10 percent of the CBD is believed to be foreign-owned.

Investor profiles for each of the three cities revealed a mix of European, Middle Eastern, Canadian, and Japanese investors. The extent of the mix varied among cities. The Washington, D.C. CBD had the heaviest concentration of European investors, Los Angeles the most Japanese. In all three cities, Japanese investors are currently the most active.

The study concluded that foreign investors have an overwhelming preference for purchasing high-quality office buildings in downtown locations. This is partly explained by the preponderance of Japanese investments picked up by the study. It is also explained by a strong cultural history for investing in downtown areas that is characteristic of foreign investors and a feeling of confidence in going with a familiar starting point (suburban office buildings are mostly American phenomena). Furthermore, because purchase decisions are subject to head office approval, a high-quality office property is the most likely to generate a positive response.

The longer a foreign investor operates in U.S. real estate markets, the more the investor is likely to adopt the same practices of American counterparts, including purchasing different property types in less central locations. This point is especially borne out by the data showing European investors in Washington, D.C. and Japanese investors in Los Angeles who have made substantial real estate investments outside the CBD, sometimes in non-office properties.

The oft-heard statement that foreign investors are paying too much for U.S. real estate is not entirely true. Japanese investors' strong preference for downtown office properties has driven them to pay more for these types of properties than American and other foreign investors are currently willing to pay. Part of this premium is due to a lack of familiarity with other types of office building investments and is expected to disappear eventually.

Foreign investors desire a longer holding period than do their American counterparts, because they perceive U.S. real estate as a safe haven for capital that offers attractive long term yields. This finding confirms that the current wave of foreign investment is not motivated by a desire to turn a quick profit.

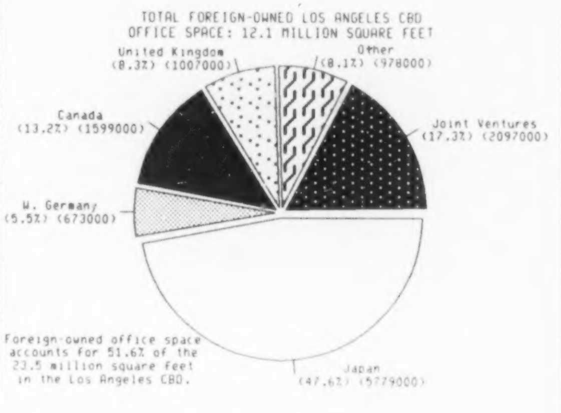
Foreign investors interviewed in all three cities were found to be relationship oriented in their approach to real estate transactions. This has two implications: Japanese investors view real estate as a long term investment so the need to quickly close an individual transaction is rarely felt; and Japanese investors prefer to establish a relationship with one firm for most of its real estate information needs. This has precedent that extends back hundreds of years within the Japanese business community. Caution will be overcome as the Japanese become more accustomed to the U.S. market.

Foreign investment transactions are indeed different from those deals involving American real estate concerns. Simple deal structures on purchases of U.S. real estate by foreign investors are the norm. Usually, the deal is a 50 to 100 percent cash transaction. Foreign investors are not comfortable with a minority ownership role.

Foreign investors are expanding their involvement in the U.S. real estate industry to include directly financing U.S. investments by U.S. investors (sometimes in exchange for an interest in the property), providing letters of credit to U.S. companies, operating leasing and building management firms, and opening Japanese real estate brokerage firms.

Copies of the study may be ordered by calling:
NATIONAL ASSOCIATION OF REALTORS®
Catalog Sales (312) 329-8218
This study is item number 186-08.
The cost of the study is $15 for Members, $20 for Nonmembers.

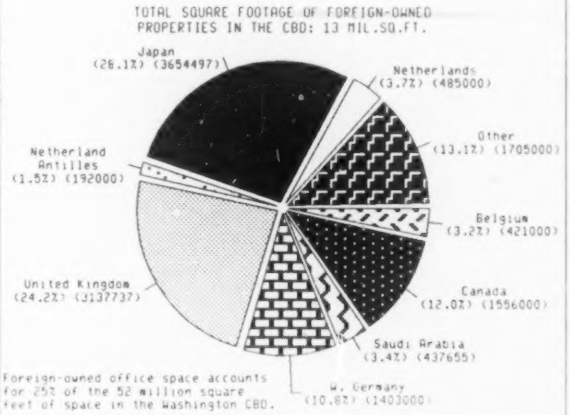
FOREIGN-OWNED OFFICE SPACE IN THE LOS ANGELES CBD



Foreign-owned office space accounts for 51.6% of the 23.5 million square feet in the Los Angeles CBD.

Source: Interviews by MIT researchers of key market participants.

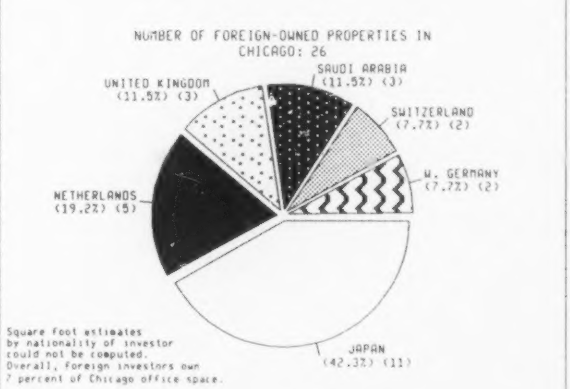
FOREIGN-OWNED OFFICE SPACE IN THE WASHINGTON, D.C. CBD



Foreign-owned office space accounts for 25% of the 52 million square feet of space in the Washington CBD.

Source: Interviews by MIT researchers of key market participants.

NUMBER OF FOREIGN-OWNED PROPERTIES IN CHICAGO BY NATIONALITY OF INVESTOR



Square foot estimates by nationality of investor could not be computed. Overall, foreign investors own 7 percent of Chicago office space.

Note: Data includes 7 pending transactions involving Japanese investors. Canadian-owned properties are not included.
Source: Interviews by MIT researchers of key market participants.

February 1988

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	Actual		Forecast						Actual		Forecast		
	1987.2	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1985	1986	1987	1988	1989
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4445	4524	4596	4638	4691	4760	4833	4922	4010	4235	4486	4731	5056
% Change	6.3	7.3	6.5	3.7	4.6	6.0	6.3	7.5	6.3	5.6	5.9	5.5	6.9
% Change (w/out inflation)	2.5	4.3	3.0	1.0	1.6	2.7	2.6	3.0	3.0	2.9	2.9	2.3	2.8
Consumer Price Inflation (CPI)	4.9	3.9	3.8	3.8	4.1	4.3	4.7	4.7	3.6	1.9	3.7	4.1	4.6
GNP Inflation (GNP Deflator)	3.5	2.8	2.7	2.7	3.0	3.2	3.6	4.4	3.2	2.6	3.0	3.1	4.0
Unemployment Rate - Civilian	6.2	6.0	5.9	6.0	6.2	6.2	6.2	6.1	7.2	7.0	6.2	6.1	6.0
Civilian Employment-Household Basis (millions)	112.2	112.9	113.4	113.7	114.0	114.4	114.8	115.2	107.2	109.6	112.4	114.2	116.0
Percent change	3.4	2.4	1.9	1.1	1.0	1.3	1.4	1.6	2.0	2.3	2.6	1.6	1.5
Index of Industrial Production	128.2	130.8	132.6	132.9	133.3	134.6	135.7	137.1	123.7	125.1	129.6	134.1	139.0
Manufacturing Capacity Utilization	80.5	81.4	82.0	81.8	81.8	81.8	81.7	81.8	80.1	79.7	81.0	81.8	81.9
Domestic Auto Sales	7.0	8.0	6.4	6.0	6.5	6.8	6.8	6.9	8.2	8.2	7.0	6.5	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.8	20.4	20.2	20.0	20.1	20.0	20.2	20.5	19.7	19.5	20.4	20.1	20.5
Federal Expenditures (NIPA) as % of GNP	23.9	23.4	23.9	23.8	23.6	23.5	23.5	23.4	24.6	24.4	23.8	23.6	23.2
Deficit(NIPA)	-139.2	-136.1	-169.5	-172.4	-163.9	-166.9	-162.7	-128.8	-196.0	-204.7	-153.8	-166.5	-133.0
as % of GNP	3.1	-3.0	-3.7	-3.7	-3.5	-3.5	-3.4	-2.8	4.9	4.8	-3.4	-3.5	-2.6
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4718	4542	4499	4264	4302	4255	4419	4397	4254	4717	4649	4310	4512
Percent change -- year ago	1.3	-3.4	-10.3	-11.8	-8.8	-6.3	-1.8	3.1	8.6	10.9	-1.4	-7.3	4.7
Existing Single-family Home Sales (thousands)	3610	3430	3420	3178	3193	3188	3338	3327	3214	3565	3520	3224	3412
Percent change -- year ago	3.8	-4.4	-12.1	-12.1	-11.6	-7.1	-2.4	4.7	12.1	10.9	-1.3	-8.4	5.8
Housing Starts (thousands)	1612	1610	1549	1537	1557	1520	1559	1573	1742	1819	1641	1543	1614
Percent change -- year ago	-14.2	-8.4	-9.0	-14.4	-3.4	-5.6	0.7	2.4	-1.4	4.4	-9.8	-6.0	4.6
Single-Family Units	1142	1147	1113	1119	1143	1100	1114	1103	1073	1188	1164	1119	1134
Percent change -- year ago	-6.2	-0.3	-4.0	-10.9	0.1	-4.0	0.1	-1.5	-2.4	10.8	-2.0	-3.9	1.3
Multi-Family Units	470	464	436	417	413	420	445	470	670	631	477	424	480
2-4 Family Units	73	58	54	52	51	52	55	59	93	85	66	53	60
Percent change -- year ago	-9.9	-24.8	-38.4	-35.1	-29.6	-9.4	2.1	12.6	-23.3	-8.6	-22.5	-20.4	13.2
5+ Family Units	397	406	382	365	362	368	390	412	576	546	411	371	420
Percent change -- year ago	-31.6	-23.6	-16.3	-20.4	-8.7	-9.4	2.1	12.6	5.5	-5.3	-24.7	-9.6	13.2
New Single-family Home Sales (thousands)	674	675	655	638	650	659	692	664	688	750	682	660	690
Percent change -- year ago	-15.1	-1.6	-7.9	-11.8	-3.6	-2.4	5.6	4.1	7.7	9.0	-9.1	-3.3	4.6
Mobile Homes Shipped (thousands)	227	241	237	240	246	243	247	248	283	249	234	244	255
HOME PRICES													
Existing Home Prices - Median ($1000)	85.1	85.5	84.5	85.7	87.3	90.2	92.5	93.4	75.5	80.3	84.9	88.9	93.6
Percent change -- year ago	3.7	5.9	5.4	1.7	2.6	5.5	9.5	9.0	4.3	6.4	5.7	4.7	5.3
New Home Prices - Median ($1000)	103.5	106.2	110.0	107.0	108.3	110.0	111.4	111.7	84.3	92.0	104.5	109.2	114.4
Percent change -- year ago	12.5	13.5	15.6	9.9	4.7	3.6	1.3	4.4	5.5	9.1	13.6	4.5	4.8
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year Fixed Rate Mortgage (FHA Secondary)	10.3	10.5	11.0	10.6	10.5	10.6	10.6	10.7	12.2	9.9	10.0	10.6	10.5
1-year ARM (without buydown)	8.1	8.3	8.3	8.4	8.3	8.5	8.6	8.6	7.6	7.9	8.2	8.5	8.6
Corporate AAA Bond Rate	9.2	9.8	10.2	9.9	9.8	9.8	9.9	9.9	11.4	9.0	9.3	9.9	10.0
Government Bond Rate	8.5	9.1	9.3	9.2	9.3	9.3	9.3	9.3	10.8	7.8	8.5	9.3	9.2
Short-Term Interest Rates													
Federal Funds Rate	6.7	6.8	7.0	6.9	6.8	7.1	7.3	7.4	8.1	6.8	6.6	7.0	7.3
3-month T-Bill Rate	5.7	6.0	5.8	6.0	6.0	6.2	6.3	6.5	7.5	6.0	5.8	6.1	6.3
Prime Rate	8.0	8.4	8.9	8.7	8.7	8.8	8.8	8.9	9.9	8.3	8.2	8.8	8.9
Discount Rate	5.5	5.7	6.0	5.9	5.8	5.9	6.0	6.0	7.7	6.3	5.6	5.9	6.3
Money Supply (M1)(% change)	6.5	0.0	4.7	4.5	6.7	6.6	6.3	6.6	9.1	13.3	11.3	4.9	6.4
Value of the U.S. Dollar (Trade-Weighted Avg.)	97.0	98.7	92.5	86.5	85.5	84.6	83.5	83.3	143.2	112.3	97.0	85.0	82.5
Percent change	-11.1	7.2	-22.7	-23.4	-4.8	-4.2	-4.9	-0.9	3.5	-21.6	-13.6	-12.3	-3.0

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE

Vol. 1, No. 3

OUTLOOK

March 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Real GNP growth in the first quarter of 1988 is expected to slow to an annual rate of 0.8 percent. The slower rate of production is due to high levels of inventories amassed during the fourth quarter of 1987. Growth in net exports and a rebound in consumer spending will bring the 1988 annual rate of real GNP growth to 2.5 percent.
- Weak economic growth in the first half of 1988 will not support a high rate of inflation, holding consumer price increases to an average annual rate of 3.7 percent in the first six months of the year. For all of 1988, consumer prices are expected to rise 3.9 percent and by 4.6 percent in 1989, when measured on a year-over-year basis.
- The risk of faster rates of inflation is relatively low. However, as more U.S. industries operate at levels close to capacity to respond to the increased demand for U.S. exports, higher rates of producer price inflation could feed through to higher prices on consumer goods.
- Federal Reserve Board Chairman Greenspan announced that the Fed had eased monetary policy earlier this year, allowing interest rates to decline. Recent signs of stronger economic growth lead him to doubt the Fed will ease further unless those positive indicators turn sour. Consequently, short-term interest rates are expected to rise in the second half of 1988.
- Mortgage interest rates are also expected to rise in the second half of 1988, due in part to the quickening pace of inflation. The average secondary market yield on 30-year FHA-insured mortgages will increase to over 10.5 percent by the end of 1988, but average only 10.3 percent for the entire year.
- January sales of existing homes declined 3.6 percent to a seasonally adjusted annual rate of 3.21 million units. Higher mortgage rates and an over-extended consumer were the likely causes of the third consecutive monthly decline. The current window of lower mortgage interest rates, coupled with a rebound in consumer spending, will help sustain demand for existing homes at an annual rate of about 3.24 million units in 1988.

IN THIS ISSUE

- **Economic Commentary: TAKING THE LONG VIEW, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Secondary Market Outlook, by Mary A. Fruscello**
- **Overview of Real Estate Provisions of New Tax Law, by Frederick E. Flick**
- **Politics, Economics and the 1988 Budget Process, by Frederick E. Flick**

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TAKING THE LONG VIEW:

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

Economics is as much psychology and culture as it is graphs and numbers. The major effects of the stock market crash of 1987, as we feel them now in the economy, have come about because of our psychological reaction. Consumers withdrew from the market not because their incomes fell (although for some this was true), but because they were convinced by the pundits and the media that the sky was falling. In fact, the crash will diminish real growth in 1988 by about 0.5 percent. But for now, the crash has left the consumer in a mixed-up mood.

Culture is also a factor in things economic. Ask anyone on the street who is the U.S.'s biggest economic competitor and you will inevitably be told the Japanese. Probe further as to reasons and the responder will inevitably cite work ethic, savings rate, newer capital, etc. In other words, our economic competition not only works with better equipment, but has a culture more suited to efficiency and profitability than our own.

Much of this is true, and perhaps the greatest cultural advantage the Japanese have is the ability to take the long view. The accomplishments of their economy over the past two decades have been built on the view that incremental accomplishments and the provision of quality will ultimately produce world economic leadership. They have focussed on the places they needed to be ten years hence, rather than next week or next month.

But, as the recent declines in consumer spending and housing starts show, we have built an expansion by focussing on today. We have built an expansion by borrowing from the future; we have not made the investments necessary to create the human and machine capital we need to sustain growth.

Our economic growth has come predominantly in service industries and mostly in entry-level jobs. We are training an entire generation to follow routine with little or no understanding of why or even how. Moreover, we're even replacing numbers on cash registers with words or pictures to further remove any mental challenge from these jobs. Yes, I'm being a little peevish here, and yes, I know that Thomas Edison and Steve Jobs came from somewhat obscure origins, but that's not the point. We will always have the entrepreneur and the technical genius overcome environment. But we are missing the tinkerers, the technicians and the mechanics that made American manufacturing competitive. We are not making the human investments we need for the future.

Is there a solution? Yes, there is, but it requires that we eat the elephant one bit at a time. As a people, we cannot build for the future if we insist on piling up enormous debts now. We need to slow the growth of consumer, government and international trade debt as a prelude to reducing it. For individuals, this requires an increased devotion to thrift. Our savings rate is currently at an historical low. It is insufficient to sustain the total volume of public and private debt that now exists. Unless we can bring that rate up, and reduce the burden of consumer debt, we are sentenced to continual high interest rates and a sluggish economy, or worse. When private debt is under control, it then becomes easier to tame the profligacy of the public sector.

In the book of Genesis, Joseph makes the climb from prisoner to prince by cautioning Pharaoh against the coming lean years, and then directing the conservation of resources against that time. Coincidentally, this current expansion will enter its seventh year next November. Now is the time to use our prosperity to build an equally prosperous future.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

Last month's announcement by the U.S. Commerce Department that the annual rate of real GNP growth for the fourth quarter of 1987 reached 4.2 percent immediately triggered warnings from many economists that too much of that growth was due to inventory accumulation. Production is expected to slow in the first quarter (and perhaps the second) as businesses attempt to sell off their excess inventories. How quickly excess stocks are depleted depends both on the extent of the expected rebound in consumer spending and the staunchness of foreign demand which is spurring on the current export boomlet. While severe winter weather combined with aftershocks from the new tax code are probably behind the housing starts decline (and not an all out housing starts bust), the sluggish activity will still drain first quarter GNP growth. The net effect of these forces on the current forecast is that the annual rate of real GNP growth is expected to slow considerably in the first quarter of 1988, to an annual rate of about 0.8 percent -- down slightly from the February forecast of 1.0 percent. On a year-over-year basis, real GNP growth is expected to reach 2.5 percent in 1988, somewhat slower than the 2.9 percent pace of 1987.

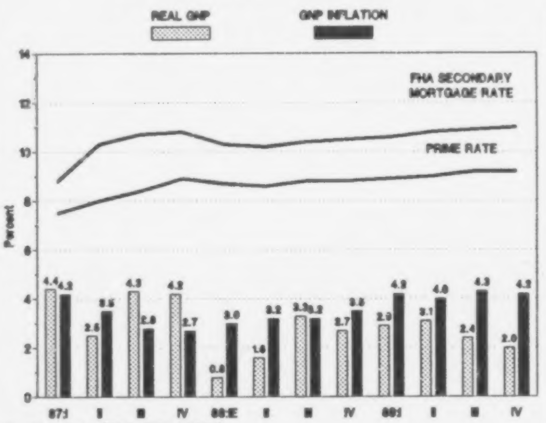
The Lowdown on High Inventories

The preliminary report on the annual rate of first quarter real GNP growth is not due to be released for two months, but already there are confirming signals that inventories are indeed swamping many businesses. The most recent data available shows business inventories in manufacturing and wholesale and retail trade rose 1.1 percent in October, 0.9 percent in November and 0.8 percent in December. The fourth quarter average rate of increase of 0.9 percent was well above the 0.5 percent average advance of the first nine months of 1987. In a sense, inventory accumulation in manufacturing industries is not as worrisome as the trade inventories because much of these stocks are intended for export. High retail and wholesale inventories are potentially troublesome because domestic demand from the U.S. consumer has been flagging in recent months.

Consumer Spending Rebound

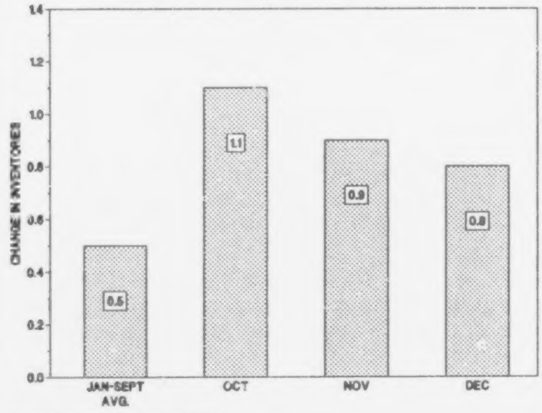
However, recent data on retail sales may indicate that consumer spending is on the rebound, which may help reduce excess inventories. In January, total retail sales were reported up 0.5 percent from their December level, and up by 0.2 percent if auto sales are excluded. In addition, December and November retail sales figures were revised upward by a total of 0.6 percent. The revised estimates show that retail sales surged ahead 1.2 percent in December (0.9 percent excluding autos) and 0.3 percent in November (0.6 percent excluding autos). According to estimates made by the Conference Board, the consumer seems to have regained much of the confidence lost in the wake of the stock market crash. In sum, while real consumer spending declined in the fourth quarter of 1987, it appears that the consumer will reverse that trend in the first quarter, possibly softening the effect of the expected production slowdown.

GRAPH 1: THE ECONOMIC OUTLOOK



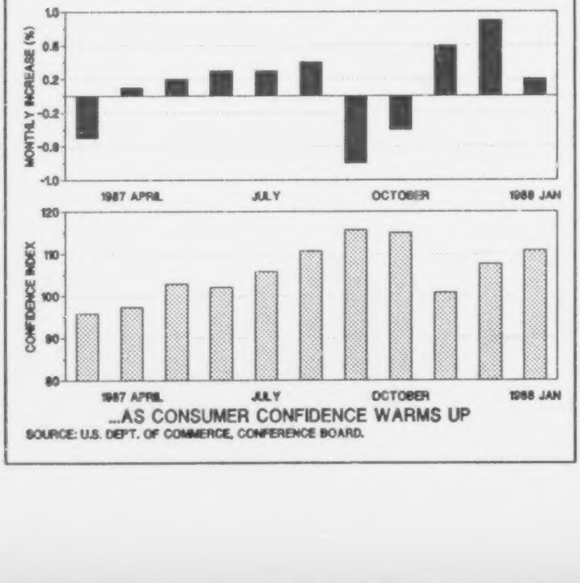
E NAR estimates (1988:I THRU 1989:IV).

GRAPH 2: MANUFACTURING AND TRADE INVENTORIES END 1987 AT HIGH LEVELS



SOURCE: U.S. DEPT. OF COMMERCE

GRAPH 3: RETAIL SALES (EXCLUDING AUTOS) REVIVE...



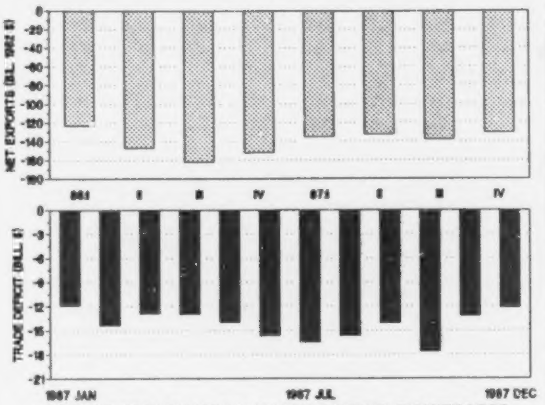
...AS CONSUMER CONFIDENCE WARMS UP

SOURCE: U.S. DEPT. OF COMMERCE, CONFERENCE BOARD.

The Export Boomlet

In two short months, the U.S. trade sector has shrugged off the mantel of economic deadbeat and is poised as potentially the largest and steadiest source of economic growth in 1988. Part of this transformation is simply a matter of perspective: real net exports have contributed positively to the economy since the fall of 1986 (with the exception of one quarter). That is, looking at the trade deficit in volume terms (by adjusting for price changes), shows that real net exports are becoming *less negative*. In so doing, they are contributing *positively* to real GNP growth. Alternatively, the monthly statistics on the nominal trade deficit have not shown steady improvement, until now. In December, the trade deficit fell to $12.2 billion from the November gap of $13.2 billion. However, most of the excitement was focused on the November statistic, with good reason: it marked a 25 percent decline from the $17.6 billion October trade deficit, the largest monthly shortfall during 1987. With the exception of the October statistic, the trade deficit declined throughout the second half of 1987.

GRAPH 4: REAL NET EXPORTS HAVE IMPROVED SINCE 1986...



...BUT THE 1987 MONTHLY TRADE DEFICIT FLUCTUATES

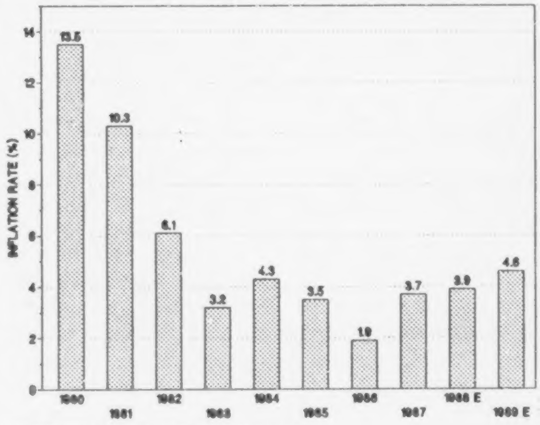
SOURCE: U.S. DEPARTMENT OF COMMERCE

Moderate Inflation Expected

The appearance of having reached the turning point with the trade deficit has helped ease the run on the dollar that began in December (the month in which the October trade report was released). The more stable dollar has in turn helped calm fears of runaway inflation in 1988. Slow economic growth through the first half of 1988, characterized by generally weak domestic demand, will also help hold down inflation. Higher prices on imported goods are expected to claim a share of consumer price inflation in 1988, as foreign producers finally pass on the cost of the lower value of the dollar to American consumers. Consumer prices are projected to rise at an average annual rate of 3.8 percent in the first half of 1988, and by an average annual rate of 4.5 percent in the second half. On a year-over-year basis, consumer prices are expected to rise by 3.9 percent this year, and by 4.6 percent in 1989.

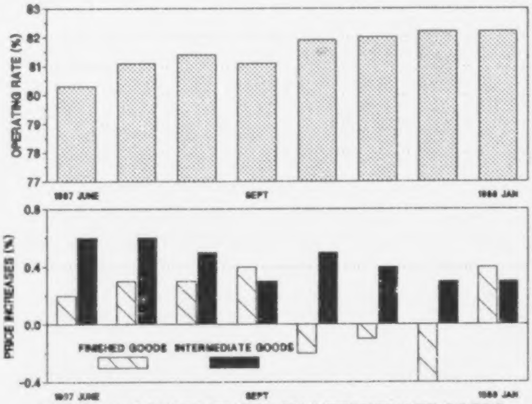
There is a significant risk to this moderate inflation forecast. First, if expected fluctuations in the monthly trade deficit prove too disconcerting for investors who hold dollars, the result could be another run on the dollar. If such a run were not managed by the world's monetary authorities as successfully as the run on the dollar in December, then the rate of inflation could rise. A more likely cause of higher than expected rates of inflation lies within our own borders. High rates of industrial production are pushing plants in many industries to produce at capacity levels. Some of this extra production is being sold overseas, accounting for the apparent trade turnabout. But, if domestic spending revives more strongly than expected, and before U.S. manufacturers can expand capacity, then U.S. manufacturers would face excess demand at high levels of capacity: a perfect recipe for higher prices. There is already some evidence that producers are charging each other higher prices for intermediate (unfinished) goods, which could lead to higher prices of finished goods. In sum, the U.S. economy can not expand at a rate of more than 2.5 percent in 1988 without risking another bout with higher prices.

GRAPH 5: MODERATE CONSUMER PRICE INFLATION EXPECTED



SOURCE: DEPT. OF COMMERCE; NAR ESTIMATES (E)

GRAPH 6: CAPACITY UTILIZATION RATES ARE HIGH...



...RAISING PRODUCER PRICES ON INTERMEDIATE GOODS

SOURCE: FEDERAL RESERVE BOARD, BUREAU OF LABOR STATISTICS

Monetary Policy and Interest Rates

Looking for signs of how the Fed might be positioning its monetary policy is a key to understanding some of the other economic indicators. This month, there are fortunately two accounts of public statements by Fed Chairman Alan Greenspan that relate to the course of monetary policy. The first came in Greenspan's first full report to Congress on monetary policy, which he delivered in testimony before the House Banking Committee on February 23. In his presentation, he admitted that the Fed had taken a "further small easing step a few weeks ago." But, he also implied that the Fed would not loosen any further unless new signs of a weakening economy came to light. This means that short term interest rates are not expected to decline much further unless the economy weakens noticeably. The second insight came in comments by Chairman Greenspan regarding an attempt by a Treasury Department official to influence monetary policy. Chairman Greenspan warned that such interference by non-Fed officials could lead to Fed actions designed to assert the Fed's independence from the White House. This was taken by some Fed-watchers as further evidence that the Fed is not backing away from high interest rates in an election year.

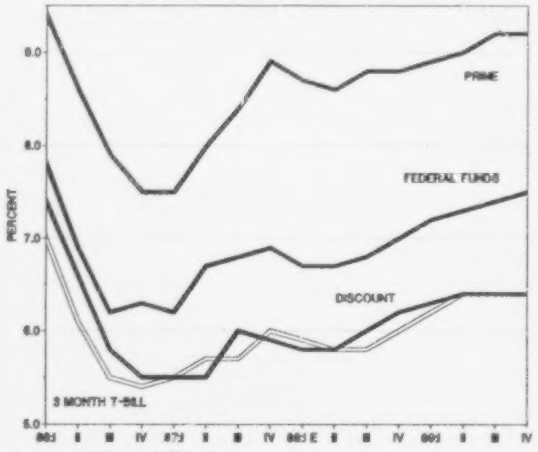
In recent weeks, long-term interest rates have been trending down, to the point where fixed rate mortgages are available at interest rates below 10 percent. With inflation fears on the wane, a modest bond market rally managed to drop long-term yields to these lower levels. Much deeper declines in mortgage rates are not expected. Gradual declines in the dollar in late 1988, should lead to faster inflation and rising mortgage rates in the second half. Furthermore, while trade will improve in real terms, continued fluctuation in reported monthly trade figures will lead investors to demand higher yields on long-term assets. Mortgage rates are expected to end the year above 10.5 percent, but average 10.3 percent for all of 1988.

REAL ESTATE MARKETS

Housing Starts

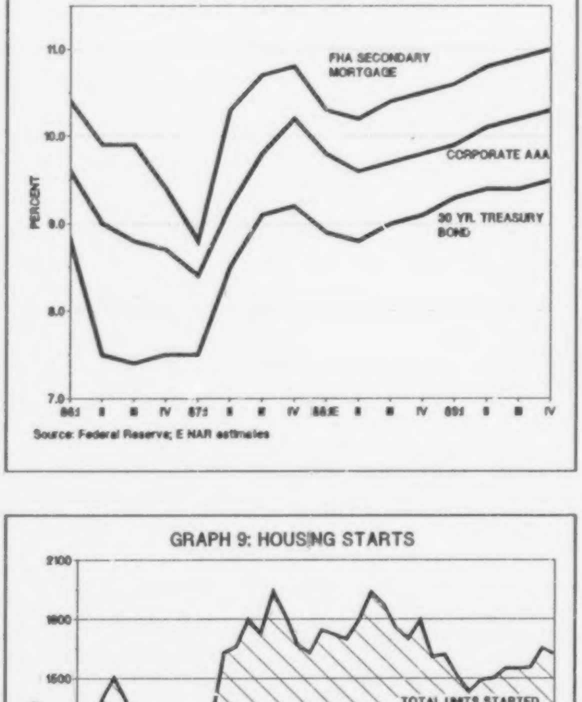
Housing starts have begun to fluctuate wildly in recent months, raising questions both about the strength of the housing market, and the accuracy of the seasonal factors used to factor in effects such as cold winter weather. In January, privately owned housing units were started at a seasonally adjusted annual rate of 1.377 million units, 2 percent below the December rate of 1.404 million units, and 24 percent below the January 1987 rate of 1.804 million units. There is some evidence that extreme winter weather in many parts of the country (beyond what is normally accounted for by the seasonal adjustment) was responsible for the large decline from the January 1987 annual rate. For the entire year, privately owned housing starts were estimated to have reached 1.621 million units in 1987, a 10.2 percent decline from the 1986 rate of 1.805 million units. After a projected slowdown in starts activity in the first half of 1988, starts should rebound in the second half to reach an annual total of 1.494 million units, down 8 percent from their 1987 level.

GRAPH 7: SHORT-TERM RATES



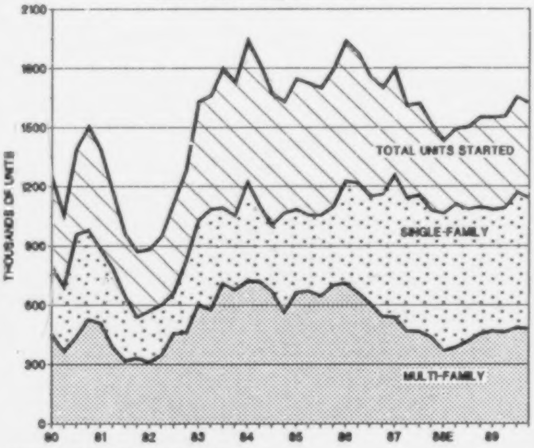
Source: Federal Reserve; E NAR estimates.

GRAPH 8: LONG-TERM RATES



Source: Federal Reserve; E NAR estimates

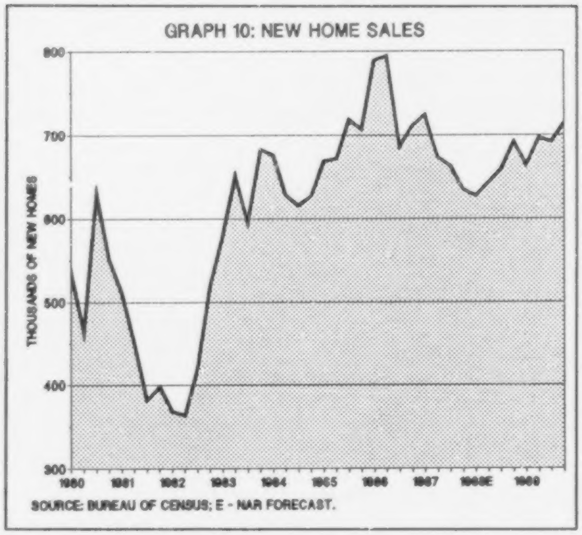
GRAPH 9: HOUSING STARTS



Source: Bureau of Census; E NAR estimates.

New Home Sales

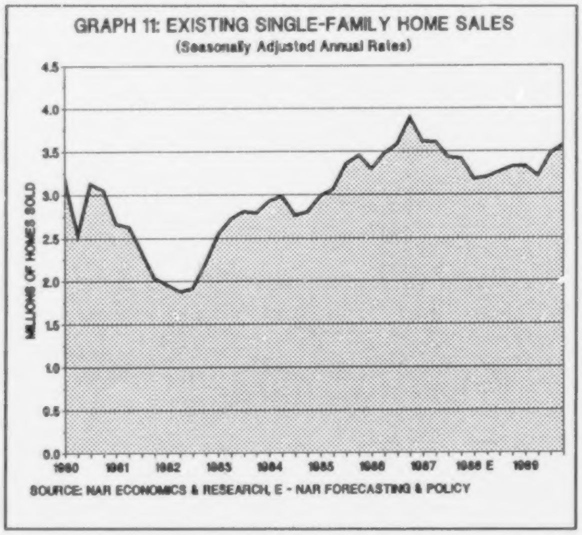
Sales of new single-family homes totaled 674 thousand units in 1987, down 10 percent from the 1986 total of 750 thousand homes. The year ended on a down note, with the annual rate of new single-family home sales slowing to only 603 thousand units in December, 6.2 percent off November's annual pace of 643 thousand units. The December rate was the slowest annual rate in 36 monthly reports. On a regional basis, new home sales declined 51 percent in the Northeast during December, offsetting sales gains in the Midwest and South (sales were unchanged in the West). New home sales are expected to continue to decline slightly through the first quarter of 1988. The rate of new home sales will likely pick up in the second quarter and continue to rise modestly through 1988. Total new home sales are expected to reach 655 thousand units in 1988, about 3 percent below the 1987 annual rate. In 1989, new homes are projected to be sold at annual rate of 687 thousand units.


GRAPH 10: NEW HOME SALES

SOURCE: BUREAU OF CENSUS; E - NAR FORECAST.

Existing Home Sales

January sales of existing single-family homes fell to a seasonally adjusted annual rate of 3.21 million units, 3.6 percent below the December annual rate of 3.33 million units. The January drop was the third monthly decline since existing home sales reached an annual rate of 3.47 million units in October. It also placed existing home sales at the lowest level of activity since June 1985. Higher mortgage rates and an over-extended consumer are the likely causes of the decline in home sales. January home sales declined in all regions except the Midwest, where the rebound in export demand is likely to have the greatest impact in 1988. After a two year period in which more than 7 million homes were sold, existing home sales are expected to decline modestly in 1988. However, the current forecast also projects a revival in consumer spending this year that could help drive home sales to consecutive quarterly increases from the expected first quarter's annual rate of 3.178 million units. The 1988 total of existing single-family home sales is expected to reach 3.24 million units.

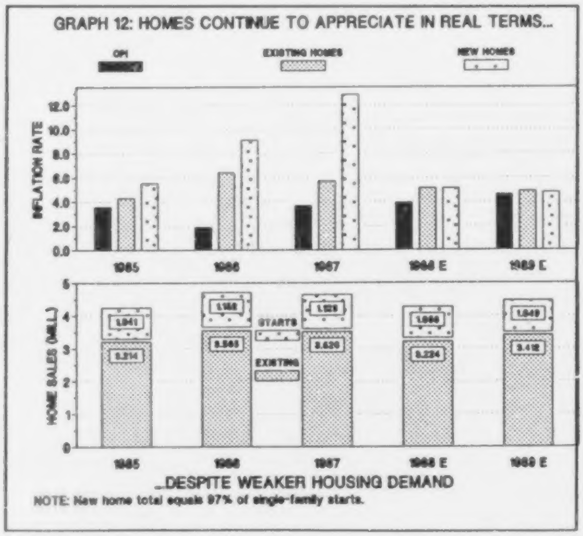

GRAPH 11: EXISTING SINGLE-FAMILY HOME SALES
(Seasonally Adjusted Annual Rates)

SOURCE: NAR ECONOMICS & RESEARCH, E - NAR FORECASTING & POLICY

Home Prices

Despite the three month decline in existing home sales, existing home prices have risen over the same period. In fact, the median price of an existing home rose to $87,900 in January, up 2.9 percent from the December median price of $85,400. Existing home prices are expected to increase by 5.1 percent in 1988, 1.2 percent faster than the 3.9 percent rate of consumer price inflation. New home prices are also expected to continue to increase in real terms in 1988. It is expected that the distortion of the new home sales sample toward higher income buyers, brought about by higher mortgage rates in 1987 will be less pronounced in 1988, explaining the decline in the expected rate of new home price appreciation.

Sean A. Burns
Research Economist
Forecasting & Policy Analysis Division


GRAPH 12: HOMES CONTINUE TO APPRECIATE IN REAL TERMS...

...DESPITE WEAKER HOUSING DEMAND

NOTE: New home total equals 97% of single-family starts.

Secondary Market Outlook

by
Mary A. Fruscello
Division Vice President
Real Estate Finance

The second level of shock waves from the slowdown in mortgage demand is now being felt. Mortgage lending operations, large and small, continue to shrink. Most recently, Lomas & Nettleton announced another 20 percent cut in staffing, bringing its total reduction to 40 percent since October.

For many lenders, particularly those who became mortgage bankers instantly through acquisition of loan servicing portfolios, the dramatic drop in volume is a harsh lesson. From their perspective, a decline in new mortgage lending presents a twofold problem. First, there is no activity to support the fixed costs and production capacity built up in the high volume period that has just ended. Large processing staffs, extensive automation and sophisticated secondary marketing activities depend upon a heavy and sustained flow of loans through the pipeline.

Second, these lenders have accumulated a sizeable portfolio of loans which they service for a fee paid by the investor. The servicing portfolio is critical; it is traditionally the primary source of profits in mortgage banking. Front end fees charged to the borrower generally cover the cost of origination (processing, closing and putting the loan on the books) and fees paid to investors for commitments to purchase the loans.

Experienced mortgage bankers expect to break even on loan sales in the long run. They recognize that gains (i.e., an excess of points charged over costs and fees paid) in some markets will be offset by losses in others. In short, the profit margins between the primary and secondary mortgage markets are narrow.

The principal source of profit in mortgage banking lies in servicing--collection of payments, accounting, reporting and remitting to investors, maintenance of escrow accounts and other activities. But profitable loan servicing requires a high level of efficiency in performing many clerical, labor-intensive functions. Most servicing operations are highly computerized, but no computer can answer customer questions or complaints, or file the dozens of pieces of paper that each loan generates, or work out a payment plan for a seriously delinquent borrower.

Making servicing profitable has become more challenging in recent years, as a variety of loan types has evolved (the more varied the portfolio, the more potential for higher servicing costs). Additionally, the servicing fee on many transactions has narrowed--conventional mortgage backed securities, for example, generally involve servicing fees of .25 percent, compared to Ginnie Maes that pay .44 percent.

Further, the loan servicing portfolio is, as financial analysts indelicately describe it, a wasting asset. Principal balances are paid down monthly, and the fee from the investor is fixed as a percentage of the outstanding principal balance. As a result, the mortgage banker must continually "feed" her servicing portfolio to maintain profit levels.

All of this means a profit squeeze in a low volume market. The search for loans to support the servicing portfolio is becoming intensive, and the market for servicing sales--bulk and individual loan (wholesale)--is beginning to heat up. Lenders are particularly fearful as rates continue to slide in the face of lackluster demand; an increase in loan payoffs could accelerate the reduction in the servicing portfolio, with the new loan landing in another mortgage banker's file.

So once again we are seeing creative marketing on the part of lenders in an attempt to maintain a modicum of volume. But in addition to the traditional marketing techniques, usually price-based, we can expect some interesting twists this time around.

One theme is convertibility--a mortgage that can flip into a fixed rate loan at some date in the future at the borrower's option. The concept isn't new, but an interesting variation has developed. It permits a fixed rate borrower to switch into a lower fixed rate loan. The idea has developed to a large extent as a means of allowing the mortgage banker to retain in portfolio a loan that might otherwise have disappeared through refinancing.

Both Fannie Mae and Freddie Mac offer purchase programs for these loans, but borrowers have so far been less than enthusiastic.

The message here is that we are likely to see other mortgage product variations develop if these market conditions persist. Mortgage bankers will increasingly become concerned about maintaining profitable servicing portfolios, and a new wave of oddball mortgages is likely to result.

DETAILED OVERVIEW OF MAJOR REAL ESTATE-RELATED PROVISIONS OF NEW TAX LAW

by
Frederick E. Flick
Division Vice President
Forecasting and Policy Analysis

INDIVIDUAL INCOME TAX

Home Mortgage Interest

The new law changes the limits on the deduction of home mortgage interest for mortgage debt incurred after October 13, 1987, as follows:

- Interest is deductible on mortgage "acquisition indebtedness" up to a total $1 million covering one or two homes. However, the deduction can be taken only to the extent that the money borrowed is used to finance the purchase or improvement of the home; and, the indebtedness limit is reduced as principal payments are made and cannot be increased by refinancing unless the additional amount is used for improvements.
- In addition to interest on acquisition indebtedness, interest may be deducted on home equity indebtedness (one or two homes) up to $100,000, irrespective of the purpose of the borrowing, provided the debt does not exceed the fair market value of the home(s).
- Interest on mortgage debt (one or two homes) incurred before October 14, 1987, is generally deductible in full after 1987. However, all mortgage debt incurred before October 14, 1987 and still outstanding is "counted" toward the new $1 million limit, but not toward the $100,000 limit.

Publicly Traded Partnerships

For tax years beginning after 1987, certain publicly traded partnerships will be treated as corporations for Federal income tax purposes. Those not so treated include certain partnerships where 90 percent or more of the gross income of the partnership consists of "passive-type income" and partnerships that qualify for a grandfather rule.

In determining whether income is treated as passive-type income in the case of interest and real property rents, amounts that are contingent on profits will not be treated as interest or rent. However, real property rents based on a fixed percentage of receipts or of gross sales are not excluded from rents that are treated as passive-type income. Passive-type income does not include income from rental or leasing of personal property.

In effect, although most Master Limited Partnerships will be taxed as corporations, publicly traded partnerships can avoid corporate taxation if 90 percent or more of the income is derived from real estate and natural resource activities. Also, this legislation recharacterizes the income from any publicly traded partnership as portfolio income that cannot offset passive losses under the passive loss limitation. However, non-publicly traded partnerships are not subject to the above limitation.

In the case of a partnership that is treated as a corporation, the partnership is treated as contributing all of its assets (subject to all of its liabilities) to a newly formed corporation in exchange for all of the corporation's stock. The stock of the corporation is treated as distributed to the partners in complete liquidation of the partnership.

Publicly Traded Partnerships Under the Passive Loss Rules

Certain publicly traded partnerships are exempt from the provision that requires them to be taxed as corporations. The passive loss provisions will continue to apply to these partnerships at the partner level. However,

- Net income from these publicly traded partnerships is treated as portfolio income.
- Income and loss from each publicly traded partnership is treated separately by a partner.
- Losses may not be used to offset regular portfolio income (as defined under the passive loss rules as they generally apply) from the partnership.
- Unused losses are suspended and may be carried forward until the publicly traded partnership generates income or until the partner disposes of his or her entire interest in the activity.

Credits from a publicly traded partnership may be used only to offset the partner's income tax liability attributable to the same partnership interest. Partners are entitled to the $25,000 (deduction equivalent) allowance with respect to rehabilitation and low-income housing credits from the activity. The provision applies to tax years beginning after 1986.

Partnership Allocations

The new law places restrictions on the ability of a partnership with both tax-exempt and taxable partners to make disproportionate allocations of income, gain, loss, and deduction among the partners to take advantage of the tax-exempt entity. This provision applies to property acquired by the partnership after October 13, 1987, and for partnership interest acquired after October 13, 1987.

ACCOUNTING METHODS

Partnership, S Corporation, and Personal Service Corporation Year-Ends

For years beginning after 1986, partnerships, S corporations, and personal service corporations generally are required to change to their owners' tax year. Partnerships and most S corporations can elect to retain their pre-1987 tax year provided the entity pays additional tax based on a formula that estimates the tax that would have been paid if the required change had been made. The new law allows calendar-year S corporations that elected S corporation status from September 19, 1986 to December 31, 1987 to use a fiscal year if the deferral period of such year is not longer than the shorter of three months or the deferral period of the year used prior to the S corporation election.

The new law allows a personal service corporation to elect to retain its pre-1987 tax year. If the election is made, payments to employee-owners must be made prorata throughout the year, or a portion of the deduction for such amounts is deferred until the next tax year.

Installment Sales

Dealer sales. The installment method of reporting gain is not available for post-1987 "dealer" sales of real or personal property. Specifically, installment method reporting is precluded for:

- dispositions of personal property by a company that regularly sells such property on an installment plan; and
- dispositions of real property that is held by a company for sale to customers in the ordinary course of business.

Gain on these dispositions must be reported in full upon sale.

Companies selling timeshares or residential lots may elect to continue to use the installment method, but must pay interest to the government on the amount of taxes deferred by the use of the method. Also, the repeal of the installment method for dealers does not apply to sales of farm property.

Non-dealer sales. The new law repeals the proportionate disallowance rules for non-dealers. These rules required the inclusion in income of a percentage of deferred gain determined based on the seller's debt-to-asset ratio.

In lieu of the proportionate disallowance rules, the new law imposes certain restrictions on installment sales of business or rental real property (except farm property) with a selling price in excess of $150,000.

- To the extent that a company's total amount of installment receivables of this type arising during any year and outstanding at the end of that year exceeds $5,000,000, interest is owed to the government on the deferred tax attributable to such excess.
- After December 17, 1987, the pledging of these installment receivables as security for a loan will trigger full reporting of gain (under prior law pledges were not treated as dispositions).

For non-dealers selling business or rental real property, the installment method may be used (for tax years after 1986) for purposes of computing alternative minimum taxable income on any non-dealer sales.

The changes regarding non-dealers are effective for sales in tax years beginning after 1987. However, companies and individuals may elect to apply the new law to all sales after August 16, 1986.

Estate and Gift Taxes

Rates

The new law continues for five years the two highest gift-estate tax brackets (53 percent for amounts between $2.5 million and $3 million and 55 percent over $3.0 million). These rates were previously scheduled to drop to 50 percent on January 1, 1988. The new law also phases out the benefit of the unified credit and graduated rates for transfers exceeding $10 million but less than $21,040,000 for decedents dying before 1992 by imposing an additional five percent tax on those transfers.

Estate Freezes

The new law includes a provision that could cause the value of certain transferred property to be included in the gross estate of a decedent.

The new rules are potentially applicable to transfers of stock after typical estate freeze corporate recapitalizations, as well as to transfers of partnership interests or other interests in income or gain-producing property.

Estate Tax Deduction for Sales to ESOP

An estate tax deduction for transfers to an ESOP is not available unless the decedent directly owned the employer securities just before death, and after the sale, the employer securities are allocated to plan participants or are held for future allocation under a leveraged ESOP or in connection with a transfer of assets from a terminated defined benefit plan. The new law limits the deduction to sales of securities of employers whose stock is not publicly traded. The deduction is limited to 50 percent of the taxable estate, and in addition, the amount of estate taxes may not be reduced by more than $750,000 by reason of the deduction.

If qualified securities for which a deduction was claimed are disposed of within three years of the sale qualifying for the estate tax deduction an excise tax is imposed upon the ESOP.

OTHER TAX PROVISIONS (NON-REAL ESTATE)

FICA Tax

The new law extends FICA taxes and Social Security coverage, effective January 1, 1988 to:

- All cash tips (up to the Social Security wage base);

- A spouse employed by his or her spouse and certain children employed by parents;
- Armed services reservists "in active duty training,"
- Certain agricultural workers;
- Employer-provided group-term life insurance if it is includable for income tax purposes (if the coverage exceeds $50,000 or is provided on a discriminatory basis).

FUTA Tax

The new law extends the 0.2 percentage point surtax on the Federal unemployment tax rate for three years.

Excise Taxes

The three percent telephone excise tax, scheduled to expire after December 31, 1987, has been extended through December 31, 1990.

Source: Coopers and Lybrand, "An Overview of the Principal Provisions of the 1987 Tax Act," Tax Notes, pp. 67-75, January 4, 1988.

TAX AND BUDGET OVERVIEW: POLITICS, ECONOMICS AND THE 1988 BUDGET PROCESS

by
Frederick E. Flick
Division Vice President
Forecasting and Policy Analysis

On Thursday, February 19, the President released his budget for Fiscal Year 1989, to take effect October 1, 1988. Of course, this is an election year and the political climate will dictate a low-profile on taxing and spending. Consequently, Washington political mavens are predicting that there will be no major battles in Congress or between Congress and the President this year.

The Taxation Outlook

Technical corrections is expected to be one of the few tax games in town this year. Since 1988 is an election year, Congress is not expected to make any serious attempts to raise revenue. Of course, the deficit prevents Congress from making any significant revenue-losing changes as well. Most observers predict that Congress will be content with just adding some of the "miscellaneous" revenue losers that were dropped from the original reconciliation bills to the technical corrections bill.

However, there may be some efforts to make significant tax changes. Proponents of restoring a capital gains tax preference are expected to push hard for their proposals this year and may receive more serious attention than they did last year.

The Current Budget Timetable

In the next few weeks, the House and Senate Budget Committees will begin hearings on the President's budget. After that, each panel will draft a budget for overall spending, revenue and deficit levels for broad categories of government activities. Currently, the House plans to have a budget ready for a vote of the House by the third week in March. The Senate is planning for the end of April. Differences are expected to be resolved by the end of May.

Following the approval of the budgets, the respective houses' appropriation committees are expected to start work in early summer on spending bills to implement these spring budget resolutions. It is hoped that final action can be completed by both chambers before October.

The Budget Accord passed in late 1987, provides some common ground on taxing and spending for FY 1988 and FY 1989. Therefore, some of the rules have already been set. However, a factor that could cause some problems is the growth rate of the economy and its impact on the budget deficit.

Assumptions On the Economy and the Deficit

Under the terms of the 1987 Budget Accord (see January 1988 issue of Real Estate Outlook), the deficit was expected to fall within the target levels set by the Gramm-Rudman-Hollings (GRH) law - $144 billion in FY 1988 and $136 billion in FY 1989. Actually, there is a $10 billion "fudge-factor," so if the FY 1989 deficit is expected to be $146 billion, it will still be considered acceptable, and therefore avoid any across-the-board cuts via sequestration of federal spending.

Private forecasters have estimated the budget deficit could reach $158 billion in FY 1988 and $167 billion in FY 1989. The trick is the economic assumptions used by the Administration to project the FY 1989 deficit.

In February, the Congressional Budget Office (an economic research arm of Congress) presented its economic assumptions to Congress. The CBO forecast economic growth of 1.8 percent for 1988 and 2.6 percent in 1989 (based on fourth quarter to fourth quarter [4Q to 4Q] percentage changes). It also predicted: a 3.9 percent increase in the GNP Deflator for 1988 and 4.2 percent in 1989; and, 4.9 and 4.8 percent increases for 1988 and 1989, respectively, in the urban CPI. In terms of the civilian unemployment rate, CBO is forecasting 6.2 and 6.1 percent calendar-year averages for 1988 and 1989. Interest rates (calendar-year averages) are forecast to be 9.3 and 9.5 percent on 10-year Treasury bonds; and 6.2 and 6.7 percent for 3-month Treasury bills for the two years. These assumptions lead to deficit projections of $157 billion in FY 1988 and $176 billion in FY 1989. Both exceed the GRH targets (including the "fudge factors").

The Administration's Assumptions

The President's men are assuming real GNP growth (4Q to 4Q) of 2.4 and 3.5 percent; CPI inflation of 4.3 and 3.9 percent (4Q to 4Q); an overall unemployment rate of 5.8 and 5.5 percent; and an average annual interest rate on 91-day Treasury bills of 5.3 and 5.2 percent for 1988 and 1989, respectively. These more optimistic expectations have allowed the Administration economists and budgeters to forecast deficits of $146.7 for FY 1988 and $129.5 for FY 1989, well within the GRH targets.

A Summing Up

The Administration is taking a considerably more optimistic view of the economic future than is the CBO or private forecasters, as reported in the Blue Chip Indicators (we are a contributor to that monthly consensus forecast). If Congress chooses to accept this rosy scenario, it can avoid any disturbing battles over the deficit and how to cut spending or raise taxes. Obviously, the political climate over the next few months will determine what will be done.

The cynics are betting Congress will turn its head and focus on re-electing itself. Furthermore, many economists are chagrined by the expected willingness of Congress to ignore the disparities in these figures and go on with the business of getting elected. Nevertheless, economists also need to be reminded that they are the ones who helped create these numbers. When taxes, spending, politicians and economists meet, what occurs is not pure politics and not pure economics. Instead we have a unique alloy -- political economy -- which combines the best and worst of each craft. The next year should be interesting in seeing the forging of this alloy, especially during a changing economy.

A COMPARISON OF ECONOMIC FORECASTS

Economic Variable/Source	Percentage Growth by Calendar Year 1988	1989
Real GNP Growth Rate (4Q to 4Q)		
CBO	1.8	2.6
Administration*	2.4	3.5
Consensus**	1.8	2.1
GNP Deflator (4Q to 4Q)		
CBO	3.9	4.2
Administration	3.9	3.7
Consensus	3.8	4.3
CPI-U (4Q to 4Q)		
CBO	4.9	4.8
Administration	4.3	3.9
Consensus	4.2	4.8
Civilian Unemployment Rate (Cal. Avg.)		
CBO	6.2	6.1
Administration	5.8	5.5
Consensus	6.2	6.3
Three-Month Treasury Bill Rate (Cal. Avg.)		
CBO	6.2	6.7
Administration	5.3	5.2
Consensus	5.9	6.4
Ten-Year Government Bond (Cal. Avg.)		
CBO	9.3	9.5
Administration	8.0	7.4
Consensus	8.9	9.1

*Some of the Administrations economic assumptions are taken from estimates published by the Council of Economic Advisers in a press release dated December 23, 1987.

**Blue Chip Indicators, January 10, 1988.

FEDERAL DEFICIT PROJECTIONS

Source	1988	Fiscal Years ($s in Billions) 1989	1990
CBO	$157	$176	$167
Administration	$147	$130	$104
GRH Target (including margin)	$154	$146	$110

Sources: Statement of James L. Blum (Acting Director, CBO) before the Committee on the Budget, U.S. Senate, February 4, 1988; "Reagan Plan for '89 Is Less Confrontational, Seeks Spending Rise for Spaces, Aids Research," The Wall Street Journal, February 19, 1988, page 12; and Rose Gutfeld, "Budget Assumes a Continued Expansion of Economy, Despite Risky Environment," The Wall Street Journal, February 19, 1988, page 12.

March 1988

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS			
	Actual		Forecast						Actual		Forecast	
	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1986	1987	1988	1989
AGGREGATE ECONOMY												
Gross National Product (billions of dollars)	4524	4598	4642	4698	4774	4847	4933	5020	4235	4486	4741	5060
% Change	7.3	6.7	3.9	4.9	6.6	6.2	7.3	7.2	5.6	5.9	5.7	6.7
% Change (w/out inflation)	4.3	4.2	0.8	1.6	3.3	2.7	2.9	3.1	2.9	2.9	2.5	2.8
Consumer Price Inflation (CPI)	3.9	3.6	3.5	3.9	4.4	4.6	4.7	4.6	1.9	3.7	3.9	4.6
GNP Inflation (GNP Deflator)	2.8	2.7	3.0	3.2	3.2	3.5	4.2	4.0	2.6	3.0	3.0	3.9
Unemployment Rate - Civilian	6.0	5.9	5.9	6.0	6.0	6.0	5.9	5.9	7.0	6.2	6.0	5.8
Civilian Employment-Household Basis (millions)	112.9	113.5	113.9	114.3	114.7	115.1	115.7	116.2	109.6	112.4	114.5	116.4
Percent change	2.5	2.3	1.6	1.1	1.5	1.6	1.8	1.8	2.3	2.6	1.8	1.6
Index of Industrial Production	130.9	133.0	132.9	133.1	134.6	135.7	137.0	138.4	125.1	129.8	134.1	138.7
Manufacturing Capacity Utilization	81.4	82.2	82.1	82.2	82.6	82.7	82.8	83.0	79.7	81.0	82.4	82.8
Domestic Auto Sales	8.0	6.7	6.9	6.7	7.1	6.3	6.9	6.8	8.2	7.1	6.8	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	20.4	20.1	20.2	20.1	20.3	20.6	20.6	19.5	20.4	20.2	20.6
Federal Expenditures (NIPA) as % of GNP	23.4	24.0	23.9	23.7	23.6	23.6	23.4	23.3	24.4	23.8	23.7	23.3
Deficit(NIPA)	-135.8	-165.9	-175.0	-164.5	-165.0	-161.2	-137.7	-133.2	-204.7	-152.8	-166.4	-134.7
as % of GNP	-3.0	-3.6	-3.8	-3.5	-3.5	-3.3	-2.8	-2.7	-4.8	-3.4	-3.5	-2.7
REAL ESTATE MARKETS												
HOME SALES												
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4550	4467	4210	4280	4312	4389	4378	4425	4717	4649	4297	4441
Percent change -- year ago	-3.2	-10.9	-12.9	18.5	-5.2	-1.7	4.0	1.1	10.9	-1.4	-7.6	3.3
Existing Single-family Home Sales (thousands)	3430	3420	3178	3204	3260	3325	3327	3365	3565	3526	3242	3392
Percent change -- year ago	-4.4	-12.1	-12.1	-11.2	-5.0	-2.8	4.7	1.1	10.9	-1.1	-8.1	4.6
Housing Starts (thousands)	1623	1517	1432	1494	1501	1551	1551	1556	1805	1621	1494	1552
Percent change -- year ago	-7.7	-10.9	-20.2	-7.3	-7.5	2.3	8.3	4.2	3.6	-10.2	-7.8	3.9
Single-Family Units	1155	1079	1064	1109	1085	1097	1084	1092	1179	1147	1088	1082
Percent change -- year ago	0.4	-6.8	-15.3	-2.9	-6.1	1.6	1.9	-1.5	10.0	-2.8	-5.1	-0.6
Multi-Family Units	468	437	369	385	416	454	468	463	631	478	406	470
2-4 Family Units	56	55	46	48	52	57	59	58	84	65	51	59
Percent change -- year ago	-27.0	-37.5	-42.1	-33.7	-6.6	3.9	26.9	20.4	-10.1	-22.3	-21.7	15.7
5+ Family Units	412	382	322	336	364	397	409	405	542	409	355	411
Percent change -- year ago	-22.6	-16.1	-29.8	-15.2	-11.7	3.8	26.9	20.4	-5.9	-24.6	-13.2	15.8
New Single-family Home Sales (thousands)	663	635	627	643	659	692	664	697	750	674	655	687
Percent change -- year ago	-3.4	-10.7	-13.3	-4.6	-0.6	9.0	5.9	8.4	9.0	-10.1	-2.8	4.9
Mobile Homes Shipped (thousands)	241	232	233	241	241	245	246	249	249	233	240	249
HOME PRICES												
Existing Home Prices - Median ($1000)	85.5	84.4	86.8	87.3	90.2	92.5	93.4	94.0	80.3	84.9	89.2	93.6
Percent change -- year ago	5.9	5.2	3.0	2.6	5.5	9.6	7.6	7.7	6.4	5.7	5.1	4.9
New Home Prices - Median ($1000)	106.1	110.6	107.0	108.3	110.0	111.4	111.7	112.8	92.0	103.9	109.2	114.4
Percent change -- year ago	13.4	16.3	9.9	4.7	3.7	0.7	4.4	4.2	9.1	12.9	5.1	4.8
FINANCIAL MARKETS												
Long-Term Interest Rates												
30-year Fixed Rate Mortgage (FHA Secondary)	10.7	10.8	10.3	10.2	10.4	10.5	10.6	10.8	9.9	10.2	10.3	10.9
1-year ARM (without buydown)	8.3	8.2	8.0	8.0	8.2	8.2	8.3	8.5	7.9	8.2	8.1	8.5
Corporate AAA Bond Rate	9.8	10.2	9.8	9.6	9.7	9.8	9.9	10.1	9.0	9.4	9.7	10.2
Government Bond Rate	9.1	9.2	8.9	8.8	9.0	9.1	9.3	9.4	7.8	8.6	9.0	9.4
Short-Term Interest Rates												
Federal Funds Rate	6.8	6.9	6.7	6.7	6.8	7.0	7.2	7.3	6.8	6.7	6.8	7.4
3-month T-Bill Rate	6.0	5.9	5.8	5.8	6.0	6.2	6.3	6.4	6.0	5.8	6.0	6.4
Prime Rate	8.4	8.9	8.7	8.6	8.8	8.8	8.9	9.0	9.2	8.2	8.7	9.1
Discount Rate	5.7	6.0	5.9	5.8	5.8	6.0	6.2	6.4	6.3	5.7	5.9	6.0
Value of the U.S. Dollar (Trade-Weighted Avg.)	98.7	92.3	88.8	88.3	86.2	85.1	84.1	83.2	112.3	96.9	87.1	82.7
Percent change	7.2	-23.5	-14.2	-2.5	-9.1	-4.9	-4.4	-4.5	-21.6	-13.6	-10.2	-5.1

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE OUTLOOK

Vol. 1, No. 4

April 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The annual rate of real GNP growth in the fourth quarter of 1987 was revised upward to 4.8 percent from 4.5 percent. This second upward revision came amid favorable monthly reports of further increases in industrial production and employment. As a result, the forecast for the annual rate of first quarter real GNP growth has been revised upward from 0.8 percent to 2.2 percent.
- Consumer price inflation has been modest so far in 1988. The average annual rate of increase in the CPI settled down to 3.0 percent during January and February. Higher inflation rates are likely in 1988, because industries are producing at or near their capacity levels, and unit labor costs are expected to rise due to higher wage settlements.
- The surprising strength of first quarter economic growth has allowed the Fed to concentrate on controlling inflation rather than on reducing the chances of a recession. Consequently, the Fed has pursued a tighter approach to monetary policy which has caused yields to begin climbing on short-term instruments. The recent fluctuations in the dollar's value have complicated the Fed's task.
- Long-term interest rates have been rising in recent weeks as the bond market rally has shown signs of slowing. As a result, mortgage interest rates have begun to rise modestly. The current forecast expects the secondary market yield of thirty-year fixed rate mortgages to rise above 10.5 percent by mid-1988. Further increases are likely in the second half of 1988 as the rate of economic growth and inflation accelerates.
- Existing home sales are showing surprising strength so far in 1988. The February annual rate of existing single-family home sales reached 3.29 million units, a 3.8 percent rise above the January annual rate of 3.17 million units. However, the February 1988 annual rate of existing home sales was still 11.3 percent below the February 1987 annual rate of 3.71 million units. Existing single-family home sales are expected to reach 3.28 million units in 1988.

IN THIS ISSUE

- **Economic Commentary: Feeding Frenzies and Other Fishy Behavior, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Special Supplement: The President's FY1989 Budget, Overview of Various Categories of Spending, by Frederick E. Flick**

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FEEDING FRENZIES AND OTHER "FISHY" BEHAVIOR:

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

Lemmings have gotten a bad rap. Fish are the real mindless creatures of nature. Most of us are familiar with the somewhat peculiar -- at least to humans -- behavior of fish travelling in schools. Seemingly without reason, hundreds of the fish will suddenly turn in unison and head in the opposite direction; seconds later, they will reverse course. Such behavior has its human counterpart in financial markets. Traders, caught up in a frenzy of mob momentum, will follow the prevailing trend with no thought to its logic or its effect on their own self-interest.

In the past, these panics have occurred infrequently -- prior to 1929, the last financial crash had occurred in 1907. Now, we see significant changes in stock prices and volume, in interest rates and currency values on a weekly basis. Why? Essentially there are five reasons:

1. Large Block Trading. Stock and bond price indexes are weighted averages of daily trades. As institutional investors (mutual funds, pension funds) have come to dominate the market, the weights have grown larger, because the average transaction is larger. This means that even small price movements tend to loom large in the indexes.

2. Technology. Computerization has given even more weight to the activities of large traders. Most big players now use computers to signal the proper time to buy and sell. The problem is that all the programs give off the same signals. When the market moves, technology will give it a further momentum. So, small swings become large.

3. Financial Journalism. With the proliferation of financial TV shows and newspapers, there has been increasing competition for stories. So, just as TV news has made stars of tin-horn felons and obscure rebellions, TV financial news has made stars out of statistics and even (ugh!) economists. Should market traders care about the monthly trade numbers? No (monthly numbers are unreliable and the true picture is shown only annually). Do they care? Probably a lot. Why? Because the financial media tell them to. The result is a jittery market that hangs on the arithmetic of obscure bureaucrats.

4. Uncertainty About the Economy. There is no clear consensus yet that the economy will continue to expand in 1988 -- at least among market participants. The crash of October 1987 so shattered confidence (remember, most of the wheeler-dealers are young enough never to have seen a bear market) that most players don't know what to believe. Hence, they soar on a "good" number and crash on a "bad" one. And it doesn't help that the media produces reams of instant analysis.

5. Internationalization. Financial markets now trade around the clock. What happens in Tokyo and London affects the U.S. long before the westward sweep of the sun has reached the shores of Maine. As the players increase in number, and as world markets enter the game, the risk of strong movement increases. Just ask the former management at Continental Illinois Bank.

Believe it or not, all this has a direct bearing on real estate. The classic good and bad news is that all financial markets are tied together: good news because the pool of funding for real estate is larger; bad news because in this skittish age price fluctuations will be more severe. That means that in 1988, we will see at least one interest rate spike of the magnitude and duration of that which occurred a year ago. In late March 1987, the announced trade deficit number for February was unexpectedly large, traders panicked and interest rates shot up. The markets are just as jittery now as they were then, and there will be some piece of news trumpeted through the media that will trigger a jump in rates and shut down our markets.

Unfortunately, the timing of rate spikes cannot be predicted. But, the economy in 1988, although weaker than last year, is growing in an atmosphere of steady rates and low inflation. So, when rates run up, hold tight and ride out the four to six week frenzy. Eventually, the fish will turn again.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

The annual rate of real GNP growth in the fourth quarter of 1987 was revised upward to 4.8 percent from 4.5 percent. The initial report of 4.2 percent real GNP growth was due almost entirely to inventory building, suggesting a production slowdown might take place in the first quarter of 1988. However, the two subsequent upward revisions and positive news from recent monthly indicators on employment and industrial production imply a stronger first quarter than previously expected. As a result, we have revised upward our estimate of the annual rate of real GNP growth in the first quarter, from 0.8 percent to 2.2 percent. While the new estimate is significantly higher, real GNP growth during the first half of 1988 is still not expected to approach the 4.5 percent average annual rate of the second half of 1987. Instead, weaker home sales and housing starts, relative to 1987, and rising interest rates in the second half of 1988, will likely hold real GNP growth to an annual rate of 2.9 percent in 1988.

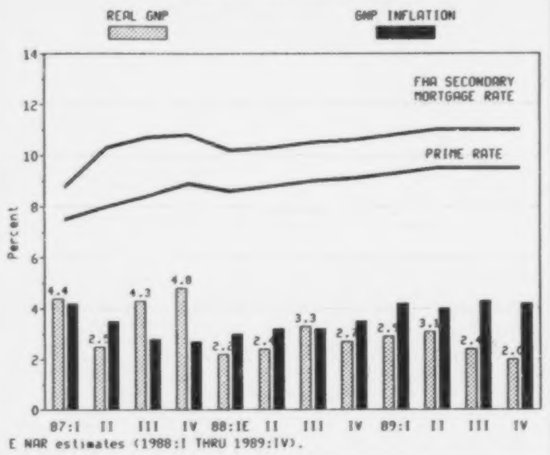
Industrial Production Still Rising

The index of industrial production continued to advance in January and February, but at a slower rate than in recent months. The index of industrial production rose 0.3 percent in January and 0.2 percent in February. Apparently, businesses are reacting to high levels of inventories by trimming production. However, gains in the index in the past year have been substantial. Gains in manufacturing production due to higher demand for U.S. exports have helped drive up the overall index. In just the past 12 months alone, manufacturing output has risen by about 6%. The manufacturing capacity utilization rate, which had also been rising almost steadily since last spring has stabilized at 82.4 percent since December. Part of this pause could be in response to high inventory levels. At present, operating rates are fast approaching the high rates of the late 1970's when many industries reached peak capacity. In fact, some industries (such as primary metals, paper, textiles, and chemicals) are already operating at or above their peak levels. Without increases in capacity to meet demand for exports, U.S. producers may begin to ration products through price increases.

Employment Gains, Unemployment Falls

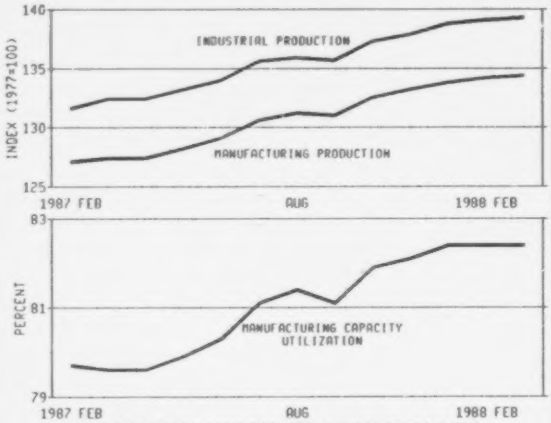
Nonagricultural payroll employment surged ahead by 531,000 jobs in February, after rising by 174,000 jobs in January. This 350,000 average monthly job gain is about the same rate of employment growth experienced in the fourth quarter of 1987, but it is a faster rate than the 250,000 average monthly job increase in the past year. Employment gains were concentrated in the service-producing industries. However, the longer term trend (shown in the graph) is steady job growth in goods-producing industries. Recent data supports this trend. In the first half of 1987, the average monthly job gain in goods-producing industries was only 22,000 jobs, compared to an average monthly gain of 83,000 through the second six months. In the fourth quarter, job gains in goods-producing industries averaged 114,000 per month. Continued employment growth cut the unemployment rate to 5.7 percent in February, almost one full percentage point below the February 1987 rate.

GRAPH 1: THE ECONOMIC OUTLOOK



E NAR estimates (1988:I THRU 1989:IV).

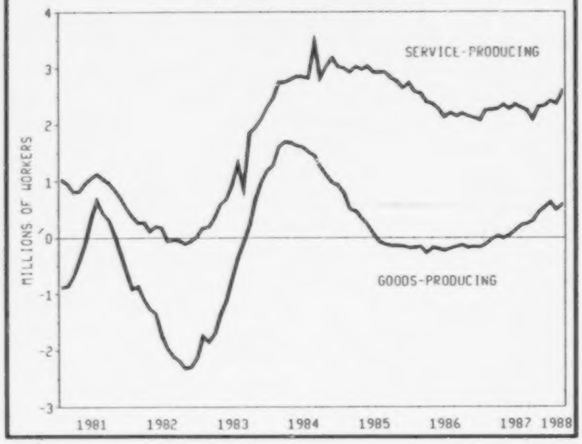
GRAPH 2: INDUSTRIAL PRODUCTION KEEPS ADVANCING...



...BUT CAPACITY CONSTRAINTS ARE BEING REACHED

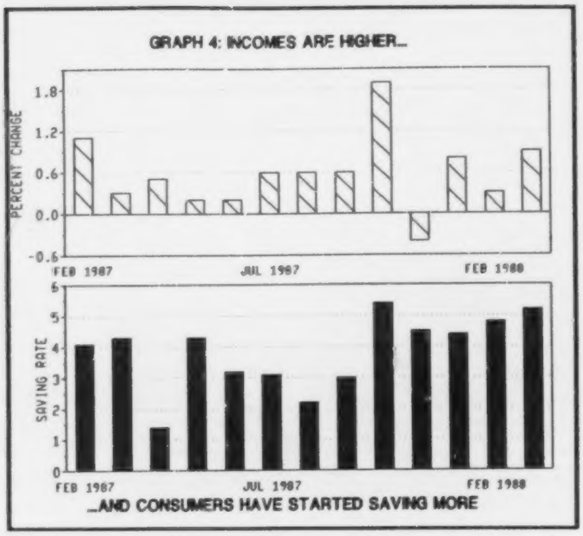
SOURCE: FEDERAL RESERVE

GRAPH 3: EMPLOYMENT GROWTH IN GOODS-PRODUCING INDUSTRIES ON THE RISE (YEAR-OVER-YEAR CHANGE)



Higher Personal Incomes Boost Savings

Personal Income rose 0.9 percent in February after increasing 0.3 percent in January. Personal income growth was actually more stable over the two month period if the combined effects of farm subsidies, cost of living increases and increased social security taxes are excluded. In that case, personal income rose 0.5 percent in January and 0.7 percent in February. In comparison, the average monthly gain in personal income during 1987 was 0.6 percent. Consumers have not been spending all of the increases, but instead are choosing to save an increasing share. This does not signal a retrenchment in consumer spending; consumer spending is expected to contribute positively to GNP growth throughout 1988. Rather, it seems to indicate consumers have put a higher premium on saving for the future in light of last October's stock market crash. The savings rate rose to 5.2 percent in February, from 4.8 percent in January, and an annual average of 3.8 percent during 1987.

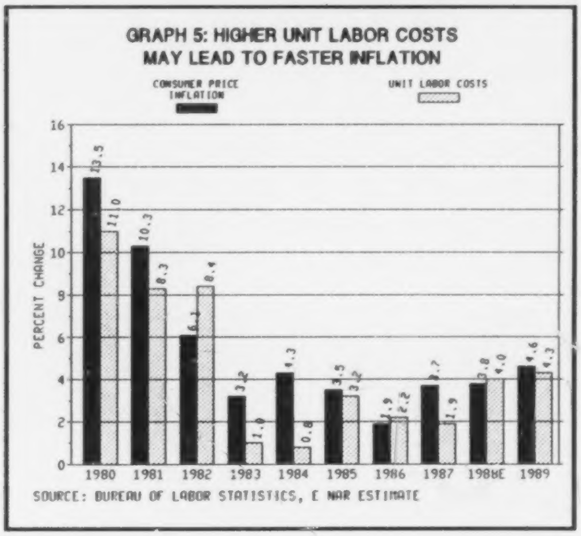


GRAPH 4: INCOMES ARE HIGHER...

...AND CONSUMERS HAVE STARTED SAVING MORE

Faster Inflation in the Second Half of 1988

The economic fundamentals of steady but slow GNP growth coupled with stable or declining oil prices bodes well for the inflation outlook in 1988. For the year, consumer prices are expected to rise by 3.8 percent in 1988, only slightly faster than the 1987 advance of 3.7 percent (year-over-year basis). During January and February of 1988, consumer prices rose at an average annual rate of about 3.0 percent. However, while the first six months of 1987 witnessed the fastest rates of inflation for the year (due mainly to sharply rising oil prices), the second six months of 1988 will likely experience the year's highest inflation rates. An important factor affecting the inflation outlook is unit labor costs, which have risen very slowly during much of the 1980's. Wage settlements for new contracts will likely be higher in 1988 and 1989, especially in light of the tight labor market conditions implied by the 5.7 percent unemployment rate. In addition, faster economic growth, further steady declines in the dollar, another climb in oil prices, and high capacity utilization rates will all likely contribute to a trend of moderately accelerating inflation which could carry into 1989.

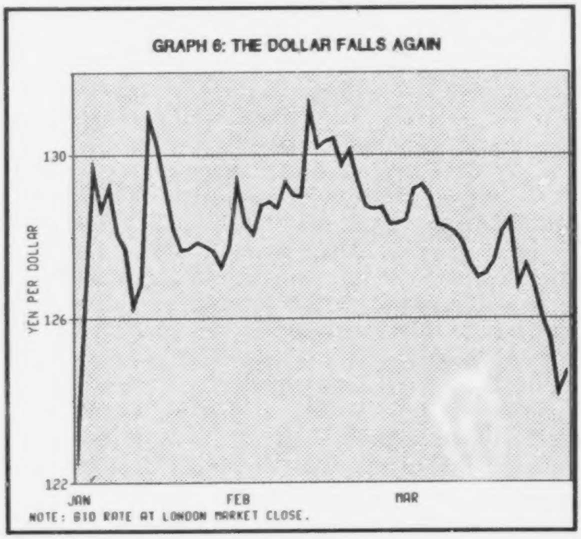


GRAPH 5: HIGHER UNIT LABOR COSTS MAY LEAD TO FASTER INFLATION

SOURCE: BUREAU OF LABOR STATISTICS, E NAR ESTIMATE

More Uncertainty About the Dollar

For international investors holding dollar assets, March came in like a lamb and went out like a lion. Late in March a run on the dollar developed, ending a period of relative stability in the dollar's value dating back to December when the world's central banks supported the dollar at about 126 yen. Some traders think that the dollar is not so much overvalued as the *yen is undervalued.* The Japanese economy is enjoying broad economic growth which is attracting funds from investors presently holding dollars. Further, reports on first quarter U.S. economic growth were stronger than expected causing some investors to fear that the American consumer will continue to buy imported goods, slowing improvement in the trade gap. Another reason for the dollar slide may be that Japanese companies holding dollar assets are adjusting their portfolios to prepare for new regulations governing how to report exchange rate losses that went into effect on March 31, the end of the Japanese fiscal year.



GRAPH 6: THE DOLLAR FALLS AGAIN

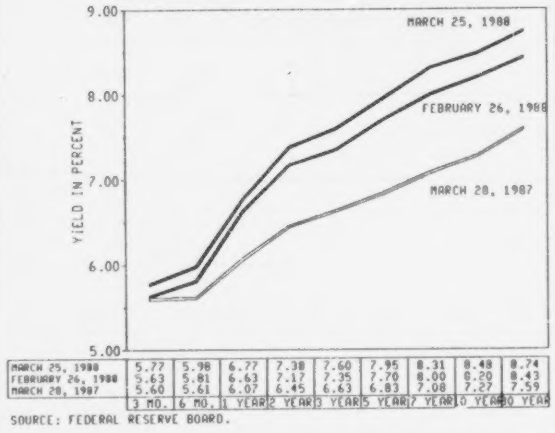
NOTE: BID RATE AT LONDON MARKET CLOSE.

Monetary Policy and Interest Rates

Yields on both short- and long-term instruments have softened since the beginning of the year. The 3-month Treasury bill yield slipped below 5.7% in early February (weekly average) and has remained at about that level through March. The Fed, confident the economy is not about to fall into a recession, has apparently decided not to encourage rates to fall any further. Instead, the Fed appears to be more concerned with keeping the inflation rate moderate. The 30-year government bond yield fell to a rate of 8.39% (weekly average) in the first week of February, and then fluctuated between 8.4% and 8.5% through the remainder of the month. By the second week of March, investors had heard enough evidence on the strength of first quarter economic growth to make them nervous about the prospects for higher rates of inflation in coming months. This nervousness was largely responsible for pushing the long-term government bond rate above 8.75% in the last part of March, before it settled back below 8.7%.

Long-term interest rates are not expected to test the lows of early 1987, when the 30-year government bond yield fell to a low of 7.3 percent in the first month of that year. Instead, there are significant upside risks to the long-term interest rate forecast. The current forecast does not assume this is the most likely scenario, instead projecting a steady rise in long-term interest rates during 1988 as economic growth strengthens in the second half of the year, paralleled by a steady decline in the value of the dollar. A resurgence of inflation beyond what is currently forecast could produce an interest rate spike later this spring or early summer. The spark for such a rapid price advance could come from increases in unit labor costs, a very important component of the inflation rate calculations done monthly by the government. Also, concerns about faster rates of inflation are already being factored into long-term yields in the credit markets. This raises the likelihood of a trend of rising long-term interest rates in 1988.

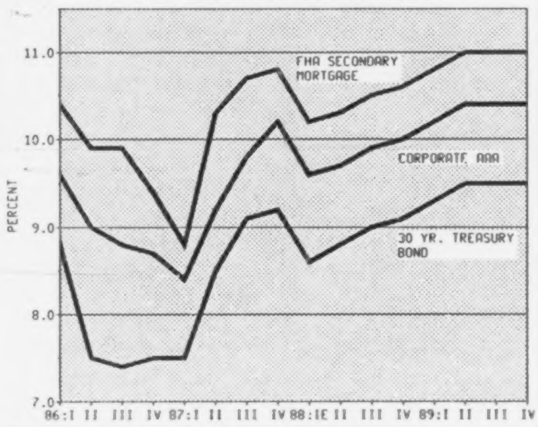
GRAPH 7: THE YIELD CURVE STEEPENS
(RATES ARE FOR U.S. TREASURY CONSTANT MATURITY ISSUES)



	3 MO.	6 MO.	1 YEAR	2 YEAR	3 YEAR	5 YEAR	7 YEAR	0 YEA	30 YEAR
MARCH 25, 1988	5.77	5.98	6.77	7.38	7.60	7.95	8.31	8.48	8.74
FEBRUARY 26, 1988	5.63	5.81	6.63	7.17	7.35	7.70	8.00	6.20	8.43
MARCH 20, 1987	5.60	5.61	6.07	6.45	6.63	6.83	7.08	7.27	7.59

SOURCE: FEDERAL RESERVE BOARD.

GRAPH 8: LONG-TERM INTEREST RATES



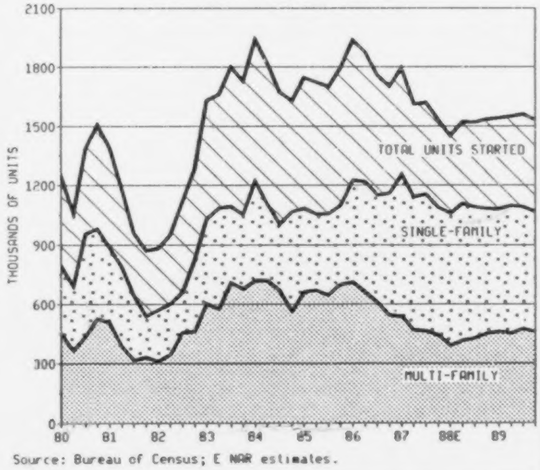
Source: Federal Reserve; E NAR estimates

REAL ESTATE MARKETS

Housing Starts

Apparently shaking off the effects of extreme winter weather and the anomalies of seasonal adjustment factors, housing units were started at an annual rate of 1.494 million units in February, 9% above the January annual rate of 1.372 million units. The February annual rate was 17 percent below the February 1987 annual rate of 1.838 million units. Total housing starts rose in the Northeast (+2.7%), the Midwest (13.8%) and the South (25.6%), but fell in the West (-9.0%). Single-family housing starts in February were reported at an annual rate of 1.095 million units, a 9% increase above the January annual rate of 1.002 million units. Multi-family units were started at an annual rate of 399 thousand units in February, 7.8 percent above the January annual rate of 370 thousand units. Total housing starts are expected to reach 1.51 million units in 1988, down 7.8 percent from the 1987 total of 1.63 million units. Single-family starts could reach 1.08 million units in 1988, 6.2 percent below their 1987 level of 1.16 million units. Multi-family starts could reach 422 thousand

GRAPH 9: HOUSING STARTS



Source: Bureau of Census; E NAR estimates.

units in 1988, down 11.5 percent from the 1987 level of 477 thousand units.

While the numbers for housing starts indicate a slowdown, it is worth noting how long and how robust this current housing starts cycle has been. The graph shows that the present housing starts cycle measures up very favorably against other recent housing cycles. In particular, the current housing cycle has reached higher levels of activity than any other, and it has maintained those higher levels longer than any other cycle. Further, it is not clear that the present cycle is near to being over. The recent negative data on starts activity in the winter months must be discounted, leaving analysts to focus on the economic fundamentals. For the short-term, the fundamentals of stable or slowly rising mortgage interest rates, the availability of adjustable rate mortgages and personal income growth imply some further growth in housing starts.

New Home Sales

New single-family homes were sold at an annual rate of 628,000 units in February, a 20 percent advance over the January annual rate of 522,000 units. However, the February 1988 gain left the annual rate of new single-family home sales 15 percent below the February 1987 annual rate of 738,000 units. Unusually bad winter weather may have been partly responsible for the wide swing in new home sales rates in the Northeast: the January-November seasonally adjusted average annual rate was 120,000 units, compared to rates of 76,000 and 82,000 in December and January, respectively. In the short-term, new home sales are expected to rise modestly, reaching a total of 646,000 units in 1988. The median new home price declined 6.1 percent in February, falling to $110,800 from the January level of $118,000. New home price appreciation will more than keep pace with inflation in 1988, after rising 12.9 percent in 1987.

Existing Home Sales

Existing single-family homes were sold at an annual rate of 3.29 million units in February, up 3.8 percent from the January annual rate of 3.17 million units. The February advance ended a three month decline, but the home sales rate remained 11.3 percent below the 3.71 million unit annual rate of February 1987. The annual rate of home sales declined by 5.4 percent in the Midwest (870,000 units), and by 1.9 percent in the West (520,000 units), but rose 8.2 percent in the Northeast (660,000 units) and 12.8 percent in the South(1.23 million units). The large decline in the Midwest is expected to be reversed by an export-led growth surge in 1988. Across the nation, existing home sales may be boosted by expectations of rising interest rates. Also, higher consumer incomes due to the export boom could contribute to higher home sales rates. Existing single-family homes should be sold at an increasingly faster annual rate during 1988, reaching a total of 3.28 million units. The median sales price of an existing single-family home rose 6.6 percent in 1987 to $85,600, and could rise 5.3 percent in 1988 to $90,100.

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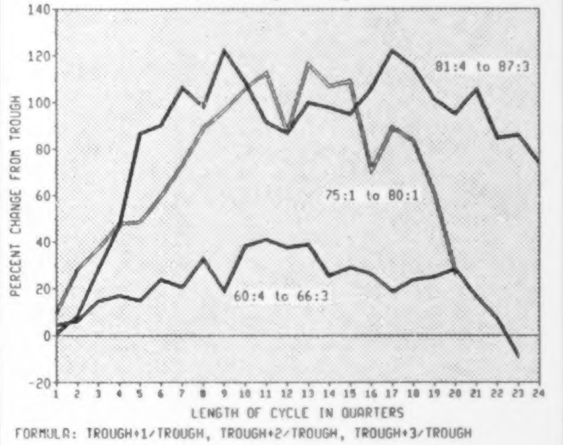
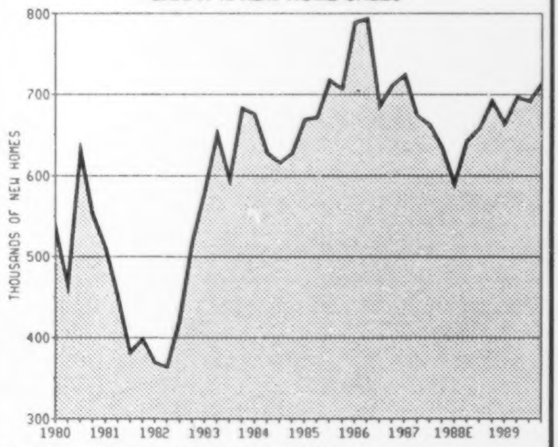
Forecasting & Policy Analysis Division

GRAPH 10: COMPARISON OF THREE LONGEST HOUSING CYCLES
(Percent change from trough)



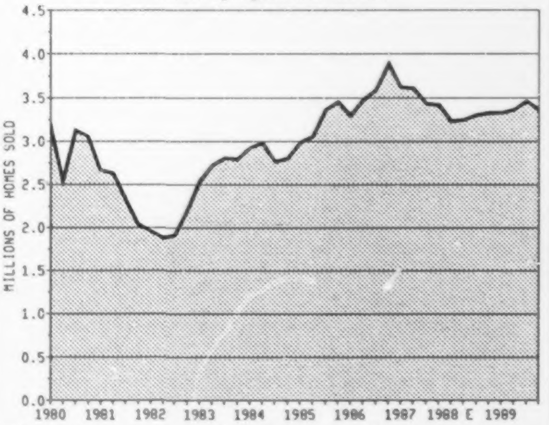
FORMULA: TROUGH+1/TROUGH, TROUGH+2/TROUGH, TROUGH+3/TROUGH

GRAPH 11: NEW HOME SALES



SOURCE: BUREAU OF CENSUS; E - NAR FORECAST.

GRAPH 12: EXISTING SINGLE-FAMILY HOME SALES
(Seasonally Adjusted Annual Rates)



SOURCE: NAR ECONOMICS & RESEARCH, E - NAR FORECASTING & POLICY

SPECIAL SUPPLEMENT:

THE PRESIDENT'S FY 1989 BUDGET, OVERVIEW OF VARIOUS CATEGORIES OF SPENDING

by
Frederick E. Flick
Division Vice President
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In mid-February, President Reagan submitted what will be his last fiscal year budget to Congress. The bottom-line total was $1.09 trillion with an estimated deficit of $129.5 that included economic assumptions ensuring compliance with the maximum deficit of $136 billion set by the Gramm-Rudman-Hollings (GRH) law. Also, because the total amount for this year had been set in the budget accord reached in November, that is another point in its favor. However, the deficit number relies on $13 million in asset sales which, according to the deficit accord, cannot count toward fulfilling the GRH target. Nevertheless, the Administration figures Congress will not fight on that point. Otherwise, there seem to be no surprises.

The Proposed FY 1989 Budget

Of the total $1.09 trillion budget, expenditures in the Social Security and Medicare function (mostly non-discretionary) comprise the largest share at $317.8. The Department of Health and Human Services budget totals $396.8 (most of which is Social Security). The second largest budget is for Defense for an outlay total of $285.5 billion, the fourth consecutive year of decline in inflation-adjusted spending. It does not achieve the 600-ship Navy and the Air Force is cutting back on the number of tactical fighter wings it desired. Furthermore, the number of uniformed personnel will be cut by 36,000 from the current 2,174,000 and a number of weapons systems will be cut. It does include a 4.3 percent increase in military pay.

The next largest component of the budget is the interest on the national debt (net of interest earned by U.S. Government accounts) estimated to total $151.8 billion in FY 1989. Outlays for Federal pensions, unemployment and other income security are expected to total $135.6 billion. These outlays are generally non-discretionary, depending on prior commitments and the state of the economy. It is important to note that Social Security/Medicare, Federal pension/income security, and Net Interest outlays total over $600 billion - more than 60 percent of the proposed budget. Finally, Defense accounts for almost 30 percent of the budget. The remaining 11 percent is spread among discretionary spending programs in nine cabinet agencies.

New Tax Breaks**

The budget also contains several non-controversial revenue losing tax breaks, mostly supported by Congress:

- A permanent research and development tax credit ($600 million revenue loss in FY 1989 and $2 billion over three years).
- Repeal of the windfall profit tax -- due to low oil prices the repeal is revenue neutral.
- Increases in the oil and gas depletion deduction for transferred properties to 100 percent (less than $100 million revenue loss in 1989).
- A branch profits tax credit for U.S. shareholders in foreign companies owning U.S. branches (less than $50 million loss in FY 1989 and $200 million over three years).
- The "67 percent" solution to Sec. 861 research expense allocation ($400 million FY 1989 revenue loss and $2.2 billion over 3 years).
- Permanent exemption of mutual fund shareholders from the two percent floor on miscellaneous itemized deductions ($400 million loss in FY 1989 and $1.5 billion over three years).
- Exempt the interest on savings bonds redeemed to pay post-secondary educational expenses (less than $50 million loss in FY 1988).

New Taxes Proposed**

To pay for these new losers, the Administration proposes to extend Medicare taxes to state and local employees, which was rejected by Congress last year. If it were adopted, it is expected it would raise $1.6 billion in 1989 and $5.7 billion over three years. Also, increases in user fees charged by the Nuclear Regulatory Commission and Federal Emergency Management Agency to raise $600 million were proposed, as well. Finally, the proposal recommends repeal of a scheduled 50 percent reduction in airway and airport trust fund taxes, saving $1.2 billion in the trust fund. The sum of the new taxes is estimated to net $700 million in FY 1989.

**Source: "President Submits Budget to Congress," and "Administration's Fiscal 1989 Budget Contains No Surprises," Tax Notes, pp. 757-759, February 22, 1988.

The Structure of the Budget

The President's budget provides the Budget Message of the President; an analysis of trends in budget policy and national priorities, a detailed statement of the priorities for the proposed expenditures; discussion of economic assumptions used in deriving the revenue and expenditure figures; a number of Special Analysis relating to issues that merit in-depth treatment; a listing of the proposed Federal program funding authority and projected outlays, and a plethora of historical data on program authority and expenditures.

The budget includes authority requests and expenditures for the Legislative and Judicial branches as well as the Executive branch (i.e., Executive Offices of the President, Cabinet Departments, and federal agencies and corporations). The figures include staff costs, management expenses, direct program expenditures, trust fund receipts, and accounting/economic concepts that are applied in measuring program outlays. The budget encompasses four printed volumes weighing approximately 10 lbs. In short, it's a veritable paradise for number drones and management accounting-types. The only qualification is that Congress takes these figures and then spends almost one year in deliberating to come up with a different set of figures. Thus, we really do not know what the "true" budget will be for a year. Furthermore, after that is done, the Administration can find some ways to avoid carrying-out some of the budget priorities through its day-to-day management of the programs.

However, since the President's budget represents a jumping-off point for the process, it is useful to examine these proposals. Furthermore, the budget is ultimately a policy tool for affecting the overall economy and the allocation of resources among various social and economic priorities.

Federal Programs by Function

The primary mode of presentation of the budget is by a functional classification which focuses on the nature of the national needs or end purposes served by the spending. In that way it is similar to the NAR budget process which looks toward the objectives of the Association's Strategic Plan. This structure includes 19 functions plus two additional categories - allowances and undistributed offsetting receipts. Each function is further divided into subfunctions, consisting of more homogenous groupings of programs.

In each functional area, the budget encompasses requested funds to be authorized or appropriated in various years, as well as funds that are projected as outlays or direct expenditures in those periods. Thus, the budget is a multi-year document involving proposed and existing authority to spend as well as proposed and anticipated expenditures. The figures also include proposed cancellations ("rescissions") of spending authority or outlays (that have not been made) and new spending through newly proposed legislation.

Relationship of Budget Authority to Outlays

The Congress must usually provide budget authority, which is generally in the form of appropriations, before Federal agencies can obligate the government to make outlays. For 1989, $1,233.2 billion of new budget authority is proposed for the Federal government. Of this amount, $974.7 billion is for agencies included in the budget and $258.5 billion is for off-budget Federal entities.

Of this total new budget authority, both on-budget and off-budget, $601.9 billion will require congressional action. New budget authority of $849.2 billion will be available through permanent appropriations under existing law. This consists mainly of trust fund receipts, which in most programs are automatically appropriated under existing law, and interest on the public debt, for which budget authority is automatically provided under permanent appropriation legislation enacted in 1847. This gross amount of new budget authority is partially offset by $218.0 billion of deductions for offsetting receipts, which consist of proprietary receipts from the public and collections of one government account from another.

Because not all of any new authority will be necessarily spent in a year (i.e., due to multi-year financing, slower than anticipated program disbursements or start-up, and long-term contract commitments) a substantial amount of budget authority carries over from one year to the next. For example, in the housing area, budget authority for large portions of the subsidized housing programs is equal to the government's estimated obligation to pay subsidies under contracts, which may extend for periods up to 20 years.

In FY 1989, $348.8 billion of the outlays (32 percent of the total) will be made from budget authority enacted in previous years. At the same time, $487.7 billion of the new budget authority proposed for 1989 (40 percent of the total amount proposed) will not lead to outlays until future years. Thus, the total budget authority for a particular year is not useful for the analysis of that year's outlays, since it combines various types of budget authority that have different short-term and long-term implications for budget obligations and outlays.

Consequently, our analysis below will concentrate on budget outlay proposals and estimates of future outlays. The discussion mentions authority when it directly affects proposed outlays.

On-Budget Versus Off-Budget Activities

The budget does not include some activities of the Federal government that result in spending similar to budget outlays. These activities, nevertheless, channel economic resources and have effects that are similar to budget spending. The total receipts and outlays of the Federal government are composed of both on-budget receipts and outlays of the off-budget receipts and outlays. These receipts and outlays of the off-budget Federal entities are a significant exclusion from the budget.

Since 1971, various laws have been enacted where several Federal entities were removed from the budget or created outside the budget. Other laws moved certain off-budget Federal entities onto the budget. Under current law, the off-budget Federal entities consist of the two social security trust funds, old-age and survivors insurance and disability insurance.

The Off-budget Federal entities are federally owned and controlled, but their transactions are excluded from the budget totals under law. When an entity is off-budget, its receipts, outlays, and surplus or deficit are not included in budget receipts, budget outlays, or the budget deficit; its budget authority is not included in the totals of budget authority for the budget; and its receipts, outlays, and surplus or deficit ordinarily are not subject to the targets set by the congressional budget resolution.

Nevertheless, the Balanced Budget and Emergency Deficit Control Act of 1985 (The Gramm-Rudman-Hollings Act) included the off-budget surplus or deficit in calculating the deficit targets under that Act and in calculating the excess deficit for purposes of that Act.

The Federal entities that were off-budget until 1986 primarily made direct loans to the public. The Gramm-Rudman-Hollings Act, however, placed on-budget all of the entities that were then off-budget. This Act also changed the budgetary status of social security. The Social Security Amendments of 1983 had already required that beginning in 1993 the old-age and survivors insurance trust fund (OASI), the disability insurance trust fund (DI), and the hospital insurance trust fund (HI) would be excluded from the budget. The GRH act required that OASI and DI be off-budget as of 1986, even though, it provided that their receipts and disbursements should be included in calculating the deficit targets. In order to provide consistent comparisons over time, the on-budget and off-budget amounts for previous years that are published in the budget documents are calculated on the basis of the current definition of off-budget entities. The transactions of HI are shown as on-budget amounts.

In 1989, the off-budget receipts are an estimated 27 percent of total receipts, and the off-budget outlays are an estimated 19 percent of total outlays. The off-budget surplus of $45.1 billion is significant. Off-Budget receipts and outlays have grown more rapidly than the on-budget amounts since 1970 and are estimated to continue growing more rapidly through 1993. The off-budget entities in total had deficits during 1976-82, but because of the Social Security increase of 1983 and an expanding economy they have had surpluses beginning in 1983 and are estimated to have growing surpluses through 1993.

The Federal Credit Budget

One area of increasing concern to the government has been the expansion of the use of Federal credit guarantees. The Federal government is the largest financial intermediary in the United States. At the end of 1987, it held outstanding loans with a face value of $234 billion in its direct loan portfolio and had another $507 billion in guaranteed loans outstanding. Government-sponsored enterprises had an additional $581 billion of loans outstanding at the end of the year. Thus, directly or indirectly, the government had influenced the allocation of $1.3 trillion of outstanding credit.

Housing guarantees dominated Federal guarantee activities during the 1950s and 1960s, and despite increases in other loan guarantee programs during the 1970s and early 1980, continue to represent a majority of all new loan guarantees. The housing programs of the FHA and Veterans Administration accounted for 84 percent of the total volume of new commitments for guaranteed loans in 1962. However, the range of activities financed with Federal guarantees has widened since that time. For the 1989 budget, housing programs account for an estimated 69 percent of all new loan guarantee commitments.

To control the growth of these guarantees, the government has created the Federal Credit Budget. This measurement tool has been used since January 1980. However, this concept represents a radical departure from traditional government accounting practices by including amounts that are not direct government costs. The Government Accounting Office (GAO) has strongly recommended against including any amounts in appropriations or outlays that are not direct costs to the government.

The Federal credit budget attempts to measure and control the volume of new direct loans and loan guarantees extended to borrowers. It is intended to measure new credit at the point at which the government legally contracts to provide a loan or loan guarantee. The credit budget is based on credit authority, is measured on a gross basis and does not reflect repayments of loans or defaults on loan guarantees. Guaranteed loan commitments are measured as the full principal of the loan, even if the government's contingent liability is less than the full loan principal. The full loan principal is included in the commitment because the entire loan, even if only partially guaranteed, is assisted by the guarantee.

The credit budget is included in the budget resolution, and limitations for many programs are enacted in annual appropriations acts. The Administration proposes limitations annually on direct loan obligations and guaranteed loan commitments for many credit programs. The limitations serve as ceilings on the volume of new credit that may be offered by the account in a given year. The limitation is specified in the appropriations language for individual budget accounts that include credit activity.

The Administration is proposing limitations in 1989 for programs amounting to 74 percent of the credit budget totals. Approximately 38 percent of direct loan obligations and 80 percent of guaranteed loans are included under the proposed limitations.

Changes in Federal Credit Measurement

As part of the Administration's efforts to control and cap Federal credit involvement, it proposed legislation in March 1987 to change the budgetary treatment of outlays involving credit. Last spring, this legislation was passed, in modified form, by the Senate but not by the House. The Congressional Budget Office was directed, in consultation with the General Accounting Office, to report as soon as possible on measuring the cost of credit programs more accurately, and comparing them with other programs. Thus, in the various subfunction outlay estimates, the line item "proposed credit reform" appears. These figures represent estimates of alleged subsidy costs using financial analysis techniques. It is important to realize that these are Administration estimates and that this controversial methodology has not yet been accepted by Congress.

Table 1

THE ADMINISTRATION'S PROPOSED FY 1989 BUDGET OUTLAYS BY FUNCTION

(In billions of dollars)

	Actual	Proposed			
	FY 87	FY 88	FY 89	FY 90	FY 91
National defense	282.0	285.4	294.0	306.2	320.2
Department of Defense - Military	274.0	277.3	285.5	297.3	311.0
Other	8.0	8.1	8.5	8.9	9.2
International affairs	11.6	9.9	13.3	13.1	15.9
General science, space, and technology	9.2	10.9	13.1	15.2	16.8
Energy	4.1	2.7	3.1	4.5	4.3
Natural resource and environment	13.4	15.1	16.0	14.7	15.8
Agriculture	27.4	22.4	21.7	19.5	18.5
Commerce and housing credit	6.2	12.4	7.9	8.6	6.8
Transportation	26.2	27.2	27.3	27.4	27.3
Community and regional development	5.1	6.3	5.9	5.9	5.2
Education, training, employment, and social services	29.7	33.7	37.4	39.1	38.5
Health	40.0	44.5	47.8	52.4	56.4
Medicare	75.1	78.9	84.0	93.7	104.0
Income security	123.2	129.6	135.6	140.6	146.4
Social security	207.4	219.7	233.8	248.5	263.4
On-budget	4.9	5.0	5.6	5.4	4.3
Off-budget	202.4	214.7	228.2	243.1	259.2
Veterans benefits and services	26.8	27.7	29.6	30.8	31.0
Administration of justice	7.5	9.0	9.9	10.3	10.5
General government	7.6	8.8	9.5	10.2	10.0
Central federal credit activities			-6.3	-7.7	-6.3
Net interest	138.6	147.9	151.8	156.7	159.6
On-budget	143.9	155.1	161.9	170.1	176.8
Off-budget	-5.3	-7.3	-10.1	-13.4	-17.2
Allowances:					
Civilian agency pay raises				0.9	2.1
Undistributed offsetting receipts:					
Employer share, employee retirement (on-budget)	-27.3	-28.7	-29.0	-31.0	-32.5
Employer share, employee retirement (off-budget)	-3.3	-4.3	-4.7	-5.5	-5.8
Rents and royalties on the Outer Continental Shelf	-4.0	-3.2	-3.9	-3.8	-4.1
Sale of major assets	-1.9		-3.3	-1.9	-0.2
Total undistributed offsetting receipts	-36.5	-36.1	-41.0	-42.2	-42.7
On-budget	-33.2	-31.8	-36.3	-36.7	-36.9
Off-budget	-3.3	-4.3	-4.7	-5.5	-5.8
Total Outlays	1,004.6	1,055.9	1,094.2	1,148.3	1,203.7
On-budget	810.8	852.8	880.9	924.2	967.6
Off-budget	193.8	203.1	213.3	224.1	236.1

Source: Budget of the United States Government, Fiscal Year 1989, Executive Office of the President, Office of Management and Budget (U.S. GPO, Washington, D.C.).

Table 2

THE ADMINISTRATION'S PROPOSED FY 1989 BUDGET OUTLAYS BY AGENCY

(in billions of dollars)

Agency	Actual FY 87	Proposed FY 88	FY 89	FY 90	FY 91
Legislative Branch	1.8	1.9	2.1	2.2	2.2
The Judiciary	1.2	1.4	1.7	1.7	1.8
Executive Office of the President	0.1	0.1	0.1	0.1	0.1
Funds Appropriated to the President	10.4	5.2	8.8	7.9	11.0
Agriculture	50.4	50.7	48.3	48.2	46.7
Commerce	2.1	2.5	2.6	3.5	2.2
Defense - Military	274.0	277.3	285.5	297.3	311.0
Defense - Civil	20.7	22.3	23.7	25.0	26.2
Education	16.8	18.8	22.7	23.9	23.2
Energy	10.7	10.5	11.8	12.8	13.5
Health and Human Services, except Social Security	148.9	160.4	168.6	181.3	196.0
Health and Human Services, Social Security	202.4	214.7	228.2	243.1	259.2
Housing and Urban Development	15.5	18.6	21.6	22.6	21.5
Interior	5.0	5.4	5.0	2.8	4.7
Justice	4.3	5.2	5.8	6.2	6.3
Labor	23.5	22.0	23.1	23.7	24.8
State	2.8	3.3	3.4	3.5	3.6
Transportation	25.4	26.3	26.4	26.5	26.4
Treasury	180.3	198.9	205.7	216.7	227.9
Environmental Protection Agency	4.9	4.9	5.1	5.4	5.2
General Services Administration	0.1	-0.1	*	0.2	0.2
National Aeronautics and Space Administration	7.6	9.1	11.0	12.7	14.1
Office of Personnel Management	27.0	28.5	30.5	33.9	35.5
Small Business Administration	-0.1	0.3	-0.4	-0.2	0.4
Veterans Administration	27.0	27.6	29.5	30.6	30.9
Other Independent Agencies	14.3	17.9	13.3	13.6	12.8
Allowances			*	0.9	2.1
Undistributed offsetting receipts	-72.3	-77.7	-89.9	-97.8	-105.6
Interest	-35.9	-41.6	-48.9	-55.6	-62.9
Other	-36.5	-36.1	-41.0	-42.2	-42.7
Total Outlays	1,004.6	1,055.9	1,094.2	1,148.3	1,203.7

*$50 million or less.

Source: Budget of the United States Government, Fiscal Year 1989, Executive Office of the President, Office of Management and Budget (U.S. GPO, Washington, D.C.).

Table 3

PROJECTED RECEIPTS BY SOURCE

(In billions of dollars)

Source	Actual FY 87	Proposed FY 88	FY 89	FY 90	FY 91
Individual income taxes	392.6	393.4	412.4	448.9	490.5
Corporation income taxes	83.9	105.6	117.7	129.3	140.6
Social insurance taxes and contributions	303.3	331.5	354.6	382.5	410.0
On-budget	89.9	91.6	96.1	100.1	104.0
Off-budget	213.4	239.9	258.5	282.4	306.0
Excise taxes	32.5	35.3	35.2	36.1	34.7
Estate and gift taxes	7.5	7.6	7.8	8.0	8.2
Customs duties	15.1	16.4	17.2	18.3	19.2
Miscellaneous receipts	19.3	19.4	19.8	20.9	21.3
Total receipts	854.1	909.2	964.7	1,044.1	1,124.4

Source: Budget of the United States Government, Fiscal Year 1989, Executive Office of the President, Office of Management and Budget (U.S. GPO, Washington, D.C.).

April 1988

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS			
	Actual		Forecast						Actual		Forecast	
	1987.3	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1986	1987	1988	1989
AGGREGATE ECONOMY												
Gross National Product (billions of dollars)	4524	4607	4667	4731	4807	4880	4967	5054	4235	4486	4772	5085
% Change	7.3	7.6	5.3	5.6	6.6	6.2	7.3	7.2	5.6	5.9	6.4	6.6
% Change (w/out inflation)	4.3	4.8	2.2	2.4	3.3	2.7	2.9	3.1	2.9	2.9	2.9	2.7
Consumer Price Inflation (CPI)	3.9	3.[illegible]	3.3	3.6	4.4	4.6	4.7	4.6	1.9	3.7	3.8	4.6
GNP Inflation (GNP Deflator)	2.8	2.7	3.0	3.2	3.2	3.5	4.2	4.0	2.6	3.0	3.4	3.9
Unemployment Rate - Civilian	6.0	5.9	5.8	5.8	5.9	6.0	5.9	5.9	7.0	6.2	5.9	5.8
Civilian Employment-Household Basis (millions)	112.9	113.5	114.1	114.5	114.7	115.2	115.7	116.2	109.5	112.4	114.6	116.4
Percent change	2.5	2.3	1.6	1.1	1.5	1.6	1.8	1.8	2.3	2.6	2.0	1.6
Index of Industrial Production	130.9	133.0	133.1	133.4	134.6	135.9	137.0	138.4	125.1	129.8	134.3	138.7
Manufacturing Capacity Utilization	81.4	82.2	82.4	82.5	82.6	82.7	82.8	83.0	79.7	81.0	82.6	82.8
Domestic Auto Sales	8.0	6.7	6.9	6.7	7.1	6.3	6.9	6.8	8.2	7.1	6.8	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	20.4	20.1	20.2	20.1	20.3	20.6	20.6	19.5	20.4	20.2	20.6
Federal Expenditures (NIPA) as % of GNP	23.4	24.0	23.9	23.7	23.6	23.6	23.4	23.3	24.4	23.8	23.7	23.3
Deficit(NIPA)	-135.8	-165.9	-175.0	-164.5	-165.0	-161.2	-137.7	-133.2	-204.7	-152.8	-166.4	-134.7
as % of GNP	-3.0	-3.6	-3.8	-3.5	-3.5	-3.3	-2.8	-2.7	-4.8	-3.4	-3.5	-2.7
REAL ESTATE MARKETS												
HOME SALES												
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4550	4467	4257	4324	4358	4374	4375	4429	4717	4649	4328	4431
Percent change -- year ago	-3.2	-10.9	-12.2	-8.8	-4.2	-2.1	2.8	2.4	10.9	-1.4	-6.9	2.4
Existing Single-family Home Sales (thousands)	3430	3420	3230	3250	3300	3325	3327	3365	3565	3526	3276	3380
Percent change -- year ago	-4.4	-12.1	-11.3	-10.6	-3.8	-2.8	3.0	3.5	10.9	-1.1	-7.1	3.2
Housing Starts (thousands)	1618.7	1532.7	1449.5	1522.4	1519.8	1533.5	1540.5	1548.5	1805	1633.9	1506.3	1545.6
Percent change -- year ago	-8	-10.7	-18.5	-5.2	-6.1	0.1	6.3	1.7	3.6	-9.8	-7.8	2.6
Single-Family Units	1154	1089.7	1058.3	1107.4	1091.2	1081.8	1080.6	1097.4	1179	1156.6	1084.6	1083.7
Percent change -- year ago	-0.2	-6.2	-15	-2.6	-5.4	-0.7	2.1	-0.9	10.0	-2.2	-6.2	-0.1
Multi-Family Units	464.7	443	391.3	415	428.6	451.7	459.9	451.1	631	477.3	421.7	461.9
2-4 Family Units	55.3	56.3	49.8	52.8	54.5	57.5	58.5	57.4	84	65.7	53.6	58.8
Percent change -- year ago	-27.8	-35.5	-37.3	-26.7	-1.5	2	17.5	8.7	-10.1	-22.6	-18.4	9.5
5+ Family Units	409.3	386.7	341.5	362.2	374.1	394.3	401.4	393.7	542	411.6	368	403.1
Percent change -- year ago	-22.3	-17.3	-24.8	-8.6	-8.6	2	17.5	8.7	-5.9	-24.4	-10.6	9.5
New Single-family Home Sales (thousands)	663	635	590	643	659	692	664	697	750	674	646	687
Percent change -- year ago	-3.4	-10.7	-18.7	-4.3	-0.6	9.0	5.9	8.4	9.0	-10.1	-4.2	6.3
Mobile Homes Shipped (thousands)	241	232	233	241	241	245	246	249	249	233	240	249
HOME PRICES												
Existing Home Prices - Median ($1000)	85.5	84.4	86.8	87.3	90.2	92.5	93.4	94.0	80.3	85.6	90.1	94.5
Percent change -- year ago	5.9	5.2	3.0	2.6	5.5	9.6	7.6	7.7	6.4	6.6	5.3	4.9
New Home Prices - Median ($1000)	106.1	110.6	113.0	111.5	113.5	114.7	115.5	116.7	92.0	104.0	113.2	117.9
Percent change -- year ago	13.4	16.3	16.1	7.7	7.0	3.7	2.2	4.7	9.1	12.9	8.8	4.2
FINANCIAL MARKETS												
Long-Term Interest Rates												
30-year Fixed Rate Mortgage (FHA Secondary)	10.7	10.8	10.2	10.3	10.5	10.6	10.8	11.0	9.9	10.2	10.4	10.9
1-year ARM (without buydown)	8.3	8.2	7.5	7.3	7.3	7.5	7.7	8.0	7.9	8.2	7.4	8.0
Corporate AAA Bond Rate	9.8	10.2	9.6	9.7	9.9	10.0	10.2	10.4	9.0	9.4	9.8	10.3
Government Bond Rate	9.1	9.2	8.6	8.8	9.0	9.1	9.3	9.5	7.8	8.6	8.9	9.4
Short-Term Interest Rates												
Federal Funds Rate	6.8	6.9	6.6	6.8	6.9	7.0	7.2	7.3	6.8	6.7	6.8	7.4
3-month T-Bill Rate	6.0	5.9	5.7	6.0	6.2	6.3	6.5	6.6	6.0	5.8	6.1	6.4
Prime Rate	8.4	8.9	8.6	8.6	8.8	8.8	8.9	9.0	9.2	8.2	8.7	9.1
Discount Rate	5.7	6.0	6.0	6.0	6.0	6.0	6.2	6.4	6.3	5.7	6.0	6.0
Value of the U.S. Dollar (Trade-Weighted Avg.)	98.7	92.3	90.3	89.8	87.8	85.1	84.1	83.2	112.3	96.9	88.3	82.7
Percent change	7.2	-23.5	-9.6	-7.4	-11.0	-7.8	-6.9	-7.3	-21.6	-13.6	-8.9	-6.3

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE OUTLOOK

Vol. 1, No. 5 *May 1988*

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The annual rate of real GNP growth in the first quarter of 1988 reached 2.3 percent, the U.S. Department of Commerce reported. While this rate was less than half the 4.8 percent advance recorded in the fourth quarter of 1987, it appears that enough of the economy's momentum in the latter half of 1987 has carried forward into 1988 to all but rule out the risk of a recession in 1988.
- Much of the concern over the prospect for faster rates of inflation in 1988 has centered on the outlook for higher wage increases this year. The most recent data shows that total compensation costs facing private firms are rising at a faster pace than last year. However, most of the increase was due to a legislated rise in the employer's social security tax rate, and was not due to a markedly faster increase in wages. As a result, consumer prices are expected to increase by 4.3 percent in 1988, compared with a 3.7 percent rise in 1987 (year-over-year basis).
- The monetary policy of the Federal Reserve appears to be directed at firming up short-term interest rates in order to calm growing inflation fears. The latest GNP report, showing the economy is in surprisingly good health, will likely hold the Fed to its tight money course, which could keep interest rates on an upward trend. The current forecast projects the FHA secondary market yield on a 30-year fixed rate mortgage to reach 10.4 percent in the current quarter, and average 10.5 percent for all of 1988.
- Sales of existing single-family homes reached a seasonally adusted annual rate of 3.33 million units in March, up 2.5 percent from the February annual rate of 3.25 million units. The February and March advances came as a result of lower interest rates and underlying demographic factors. Existing single-family home sales are expected to reach an annual rate of 3.31 million units in 1988, 6.0 percent less than the 1987 total of 3.53 million units. The 1988 total should rank as the third best year for existing home sales in the 1980's.

IN THIS ISSUE

- **Economic Commentary: PLAY BALL! by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Trends in Housing and Urban Development Outlays & Budget Authority, by Frederick E. Flick**
- **Real Estate Profile: First-Time Homebuyers in the Spring 1988 Marketplace**
- **Highlights from *1988 Guide to Industrial and Office Real Estate Markets***

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PLAY BALL!

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

Spring is a wonderful time because it means the return of baseball. Old men dressed like little boys play a game locked in the eternal freshness and optimism of a reborn world. In April, all teams (yes, even the Orioles) are pennant winners, and all players are most valuable. No small part of the enduring appeal of baseball is its association with spring, but there is an attraction in the very nature of the game. Set within a well defined geometric frame, and subject to a code of well-specified rules, the game unfolds as the result of a myriad of independent decisions taken freely by human beings operating within that framework. Indeed, the excesses of the game have a tendency to be self-correcting. If the hitters get ahead of the pitchers, someone invents and perfects a split-fingered fastball that reins in excessive power. If the pitchers get too smart, the offense runs and bunts more to build runs. It is no wonder that the great literate sports writers like Roger Angell and Thomas Boswell are attracted primarily to baseball. Its dimensions, outcomes and possibilities are endlessly fascinating. In short, it is a microcosm of life.

What prompts these musings is the recent success of trade protectionism, most visibly represented by the progress through Congress of a trade bill that would attempt to manage international economic relationships by "loading" the system in favor of the poor, downtrodden U.S. If baseball is analogous to the free market, where what's broke gets fixed automatically, then trade protectionism is equivalent to forcing Wade Boggs or Don Mattingly to bat blindfolded every other turn because they are more proficient hitters.

Let's push the analogy a bit further. In the 1950s, the Yankees were baseball's dominant team. But rather than force Mickey Mantle to run 120 feet to reach base, or make Whitey Ford pitch righthanded or even tape over Yogi Berra's mouth, baseball compensated by doing things that matched their excellence. The Yankee farm system worked, so other teams built theirs; the Yankees spent money on players, so other teams followed suit. Eventually because of their own efforts and because the New Yorkers got complacent and sloppy, other teams caught and passed the Yankees.

The lesson here is one that needs learning. We cannot and should not meet international competition by protecting our own uncompetitiveness. Doing so only intensifies the cause of the problem and precludes long-run and real solutions. The falling dollar is one element of the puzzle. As it deteriorates against the currencies of our trading partners, the demand for American products will automatically increase. We have seen this occurring over the past eighteen months as exports have steadily expanded. As we become overburdened by debt and are forced to save more, our appetite for foreign goods will diminish and imports will fall. We will see this as the year progresses.

But merely relying on the rules of the game is not enough. To quote that famed double-play combination, Shakespeare to Cassius to Brutus, "The fault, dear Brutus, is not in the stars; it's in ourselves." Those teams -- Washington, Cleveland, the Chicago Cubs -- who did not learn about emulating the Yankees never achieved any degree of success. We need to alter our own methods of production, distribution and merchandise to meet international challenges. There are few, if any, secrets in the world of business. The Japanese, to give one example, outstripped the U.S. by improving on its methods, not by inventing new ones. We have the same opportunities. It is a challenge we will meet only by being willing to become more efficient, more productive and smarter than the next guy, within the context of the market and its rules. We cannot win by attempting to load the system in our favor through artificial restrictions.

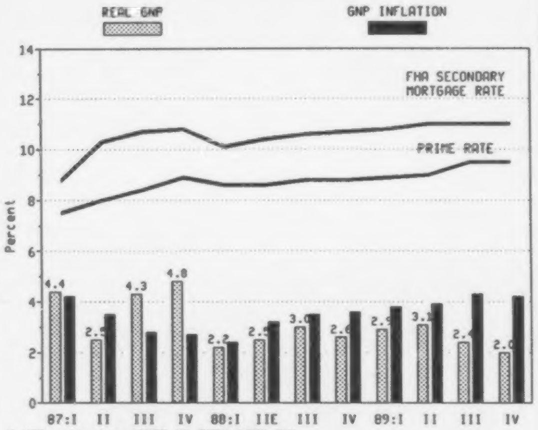
Times change and what was up may soon be down -- ask any Baltimore Orioles devotee. Ten years ago, we worried about the Arabs owning all we had. Now we worry about the Japanese. It seems, however, that in this world of technological wizardry, it is the fate of the front runner to be picked off. We haven't had a repeat World Series winner in a decade, and maybe there will no longer be a single, dominant international economy. Maybe anyone who is willing to work hard and think deep thoughts has the chance to stand astride the market -- for a while. Remember, as that Great American philosopher, Satchel Paige, put it : "Don't look back; you never can tell who's gainin' on you."

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

Well into its sixth year, the economic expansion advanced further in the first quarter of 1988, according to the most recently available economic indicators. The U.S. Department of Commerce reported that the annual rate of real GNP growth in the first quarter of 1988 reached 2.3 percent. While this rate was less than half the 4.8 percent advance recorded in the fourth quarter of 1987, it brought welcome reassurance that the effects of the stock market crash had not brought the economy to the brink of a recession. It now appears that enough of the economy's momentum in the latter half of 1987 has carried forward into 1988, yet probably not enough to push inflation up at a faster rate. However, the risk to this "just right" rate of economic growth may be a slowly improving trade deficit that could cause another slide in the dollar. The current forecast projects that real GNP will rise by 2.9 percent in 1988, with the second half of the year stronger than the first six months.

GRAPH 1: THE ECONOMIC OUTLOOK

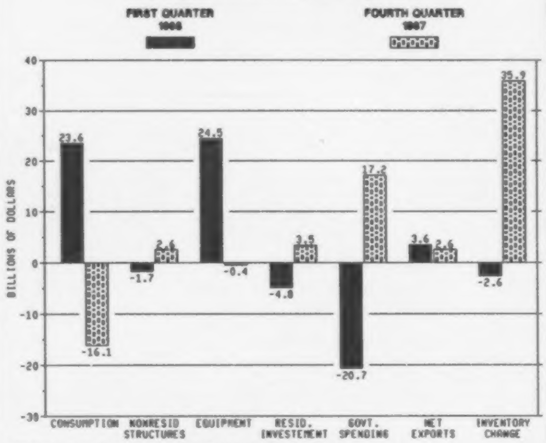


E NAR estimates (1988:II THRU 1989:IV).

Changing Composition of GNP Growth

Not only are the magnitudes of the fourth quarter and first quarter GNP numbers different, their compositions are much like mirror images of one another. While consumer spending fell sharply in the fourth quarter, its strong rebound in the first quarter explained most of the GNP advance. Similarly, business spending on equipment was almost flat in the fourth quarter, but it rivaled consumption spending for the role as sectoral leader in first quarter growth. Residential investment was off slightly in the first quarter report, after having risen in the fourth quarter. In sum, these and all other components of real final sales advanced at a 2.6 percent rate, after moving up by only 0.9 percent in the fourth quarter. The balance of the GNP growth rate is determined by the change in business inventory investment. A surge in export demand led to soaring business operating rates, but also helped create an inventory overhang. A production slowdown was expected to correct the inventory imbalance, but it proved milder than expected because of the indomitable spirit of the American consumer.

GRAPH 2: CONSUMPTION AND BUSINESS INVESTMENT LEAD FIRST QUARTER REAL GNP GROWTH

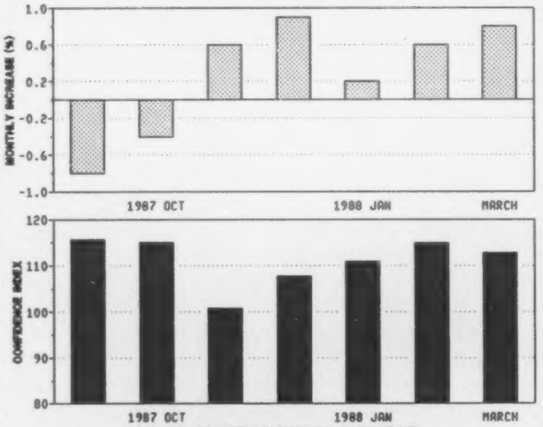


SOURCE: DEPT. OF COMMERCE, BUREAU OF ECONOMIC ANALYSIS

Retail Sales Surge Ahead

Just prior to the stock market crash, consumers were riding high on good feelings about the prospects for continued economic growth. Much of that confidence was diluted in a few short hours last October. However, since that fateful afternoon consumer confidence has been on the mend, as measured by the Conference Board. Not surprisingly, consumer spending also is on the upswing again after slumping through much of 1987. In four of the last five months, retail sales (excluding the volatile auto component) have increased by rates much higher than the average monthly gain for 1987. These higher monthly advances are not just statistics: they translate into significant gains in real GNP, documented by the first quarter real GNP report. Consumer spending is expected to be a key component of successive quarterly growth in output during 1988. But the resurgence in consumer spending does carry with it some of its own pitfalls. Namely, as long as consumers are in the mood to spend they will likely also remain somewhat partial to imported goods.

GRAPH 3: RETAIL SALES (EXCLUDING AUTOS) SURGE...



...AS CONSUMERS REMAIN UPBEAT

SOURCE: U.S. DEPT. OF COMMERCE, CONFERENCE BOARD.

Employment Costs Could Rise

Much of the recent debate over the prospects for faster rates of inflation in 1988 has centered on the outlook for higher wage settlements. The most recent data on the subject does not support the notion that wage settlements will be much higher in 1988 than in 1987. This data came from the U.S. Bureau of Labor Statistics, which reported that the Employment Cost Index rose 4.1 percent for the year ended in March. The ECI index takes into account changes in total compensation costs, which include wages, salaries, and employer costs for employee benefits. Compensation costs for workers at private sector firms rose 3.9 percent in the 12 months ending in March, the first time that March-to-March compensation cost increases were faster than the previous year. However, the wages and salaries component of the index rose only 3.3 percent, only slightly higher than the 3.2 percent March 1987 gain. Instead, the biggest source of the private sector rise was benefit costs, which surged 5.8 percent, twice the 2.9 percent March 1987 rise. This acceleration was due to a legislated rise in the employer's social security tax rate from 7.15 to 7.51 percent, and steeper health insurance costs.

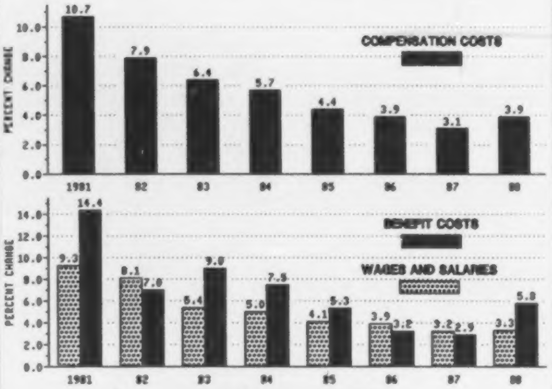
Exports Grow, But Trade Deficit Persists

While most of the reports on the economy's health indicate clear sailing ahead, the monthly fluctuations in the trade deficit still are cause for some concern. According to the most recent data available, the February trade deficit widened to $13.8 billion, from $12.5 billion in January. This news raised concerns in the world's financial markets, and cast doubts over the effectiveness of renewed pledges for economic cooperation announced by the world's financial ministers the day preceding the trade report. However, the trend in trade is still positive: February exports rose to $23.6 billion, up from $22.3 billion in January. Most of the concern is focused on the import figures, which showed imports rising to $37.4 billion in February, from $34.8 billion in January. There is a message in these numbers. The trade deficit is improving, but it could be slowed by a resurgence of U.S. economic growth that boosts consumer incomes and demand for imports.

Willingness to Hold Dollars Is Key

As U.S. consumers buy imports, the foreign producers of those imports must decide how to invest their earnings. U.S. dollar-denominated assets have been very attractive to foreign investors for a number of reasons, not the least of which is the interest rate differential. But the slow decline in the trade deficit has brought further declines in the dollar. As a result, many of these foreign investors have watched the foreign currency equivalent of their dollar investment fall. For example, a Japanese government bond offering a 4.5% return is more than 4% below the yield of a comparable U.S. Treasury. For a 10-year instrument, that differential provides enough cushion for a Japanese investor to absorb a 30% decline in the dollar's value against the yen. However, the dollar has declined by more than 30 percent, thereby pulling down the total return of these dollar-denominated assets. The risk is that these foreign investors could demand higher interest rates in order to continue to hold dollar investments.

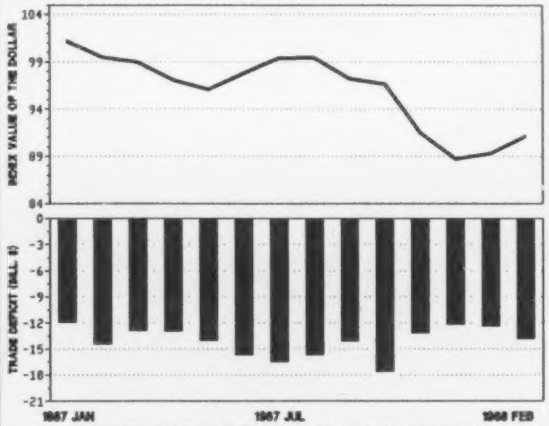
GRAPH 4: TOTAL WORKER COMPENSATION RISES...



...BUT WAGES HOLD STEADY

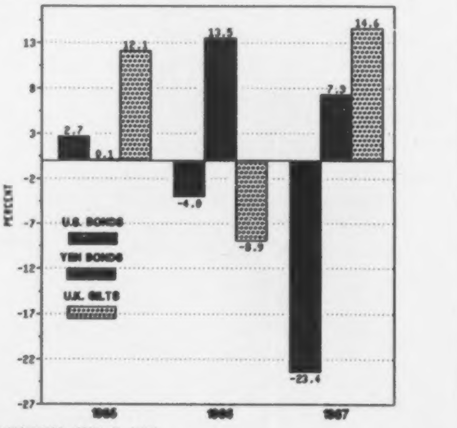
NOTE: DATA FOR YEAR ENDING IN MARCH.
SOURCE: BUREAU OF LABOR STATISTICS

GRAPH 5: THE DOLLAR HAS DONE ITS PART...



...BUT THE TRADE DEFICIT IS SLOW TO RESPOND
SOURCE: U.S. DEPARTMENT OF COMMERCE

GRAPH 6: TOTAL RETURN TO JAPANESE INVESTORS HOLDING U.S. BONDS, YEN BONDS, AND U.K. GILTS (IN YEN TERMS).



SOURCE: THE ECONOMIST, APRIL 2, 1988

Monetary Policy and Interest Rates

The accompanying graph of the yield curve shows how the Fed has been trying to hold the line on interest rates while keeping inflationary expectations in check. After the October stock market crash, the Fed provided enough money to meet the short-term demand for increased liquidity. Earlier this year, concerns about keeping the economy from falling into a recession led the Fed to postpone tightening up on the money supply. Recently, the Fed has been convinced that the economy is not at risk of falling into a recession. As a result, the Fed has tightened up on short-term interest rates, hoping to head off fears of rising inflation. The result of this has been a gradual shift upward in the yield curve over the last two months. In addition to the general shift, long-term interest rates (particularly sensitive to inflation fears) have risen steadily over the period, causing a marked steepening in the yield curve. The latest GNP report will likely hold the Fed to its tight money course aimed at stifling inflation.

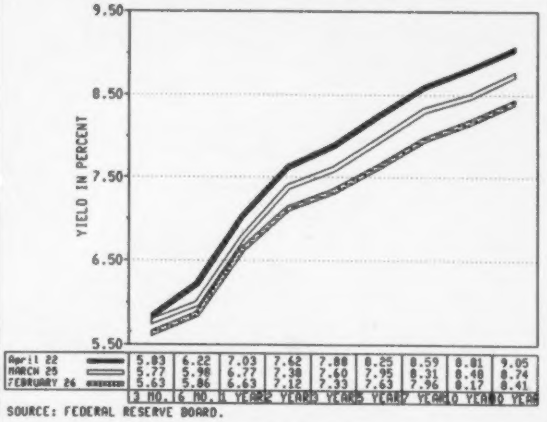
As the Fed follows this monetary policy tack, the financial markets will be keenly watching for signs of a resurgence of inflation. Chairman Greenspan's every public statement will be analyzed for his sentiments toward the rate of price change. If the financial markets detect a lessening of concern on his part regarding the inflation outlook, then it will likely cause even more inflation fears. Further, the slow improvement of the trade deficit will continue to grab the headlines and focus attention on the likelihood of further declines in the dollar. Consequently, the potential for long-term interest rates to gradually rise remains a cornerstone of this forecast. The probability that mortgage rates will be higher next year than they are now is significant. The current forecast projects the FHA secondary market yield on a 30-year fixed rate mortgage to reach 10.4 percent in the current quarter. That rate is expected to rise steadily during the remainder of the year, reaching an annual average of 10.5 percent for 1988. In the spring of 1989, that interest rate is expected to reach 11.0 percent.

REAL ESTATE MARKETS

Housing Starts

In March, privately owned housing units were started at a seasonally adjusted annual rate of 1.543 million units. This rate was 2 percent above the revised February rate of 1.514 million units. The March annual rate was 10 percent below the March 1987 annual rate of 1.723 million units. Starts of single-family units in March 1988 reached an annual rate of 1.185 million units, a rate 7 percent faster than the February pace of 1.106 million units. Multi-family units were started at an annual rate of 358 thousand units in March., 12.3 percent off the revised February pace of 408 thousand units. Housing starts activity was uneven on a regional basis, with the West region posting the only gain. This latest report on housing starts activity confirms that the housing sector is still robust, even this late in such a prolonged economic expansion. A combination of demographic factors and the potential for higher mortgage rates will likely push housing starts to an annual total of 1.53 million units in 1988.

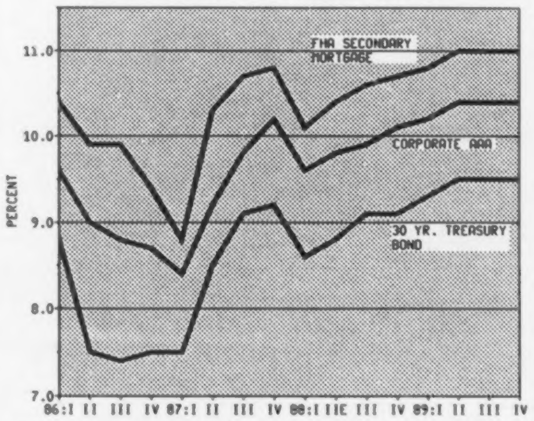
GRAPH 7: THE YIELD CURVE STEEPENS
(RATES ARE FOR U.S. TREASURY CONSTANT MATURITY ISSUES)



	3 MO.	6 MO.	1 YEAR	2 YEAR	3 YEAR	5 YEAR	7 YEAR	10 YEAR	30 YEAR
April 22 ▬	5.83	6.22	7.03	7.62	7.88	8.25	8.59	8.81	9.05
MARCH 25 ▭	5.77	5.98	6.77	7.38	7.60	7.95	8.31	8.48	8.74
FEBRUARY 26 ▨	5.63	5.86	6.63	7.12	7.33	7.63	7.96	8.17	8.41

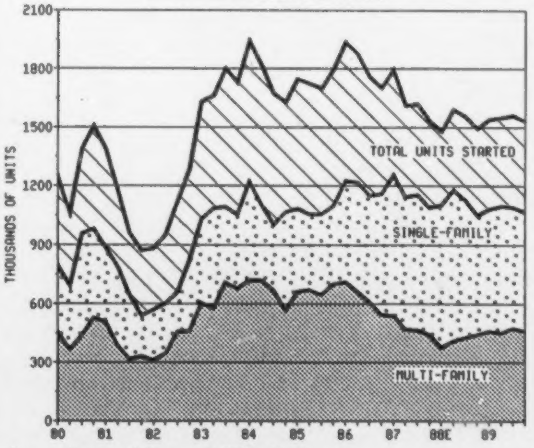
SOURCE: FEDERAL RESERVE BOARD.

GRAPH 8: LONG-TERM INTEREST RATES



Source: Federal Reserve; E NAR estimates

GRAPH 9: HOUSING STARTS



Source: Bureau of Census; E NAR estimates.

New Home Sales

Sales of new single-family homes reached a seasonally adjusted annual rate of 655 thousand units in March, a 4.0 percent rise above the revised February annual rate of 630 thousand units. Previously, the annual rate of new single-family home sales had remained below 600 thousand units in December and January, at 586 and 552 thousand units, respectively. The welcome news on new home sales combined with the improving performance of housing starts activity helps frame a positive outlook for the spring buying and building season. The low mortgage interest rates available during March was the most significant factor leading to the resurgence in demand for new homes. There are also demographic trends powering home sales to levels that might appear unusually strong, this late in the housing cycle. The current forecast projects sales of new single-family homes to reach 639 thousand units in 1988, down 4.7 percent from the 1987 total.

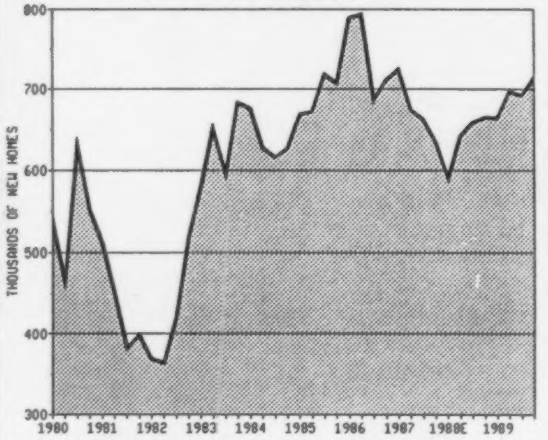
Existing Home Sales

Sales of existing single-family homes reached a seasonally adjusted annual rate of 3.33 million units in March, up 2.5 percent from the February annual rate of 3.25 million units, but down 9.8 percent from the March 1987 annual rate of 3.69 million units. On a regional basis, the February to March advance was concentrated in the West (9.6 percent increase) and the South (6.7 percent increase); sales in the Northeast were unchanged but were off slightly in the Midwest (3.4 percent decline). The number of existing single-family homes on the market reached 2.72 million in March, which, given the March sales pace, translates into a 9.8 month supply. Renewed vigor in existing home sales has been largely due to lower interest rates during the opening months of 1988. While mortgage rates are expected to gradually rise during 1988, two other factors are likely to keep the rate of existing home sales healthy. First, the popularity of adustable rate mortgages (ARM) is again on the rise. *The Home Financing Transaction: Spring 1988* report found that 31 percent of home purchases in its sample were financed with an ARM, compared to 8 percent during the same period last year. (A summary of this report appears in this issue.) Second, the demographics of housing demand point toward a sustained period of existing home sales at a rate of at least 3.2 million units. For these reasons, existing home sales are expected to reach an annual rate of 3.31 million units in 1988, 6.0 percent less than the 1987 total of 3.53 million units. At that annual rate, the 1988 total would rank as the third best year for existing home sales in the 1980's.

The modest slowing in demand for both existing and new homes in 1988 will not stall the rate of price increases on these properties. The median existing single-family home price is expected to rise by 5.4 percent in 1988. New home prices could rise by a faster rate of about 8.3 percent.

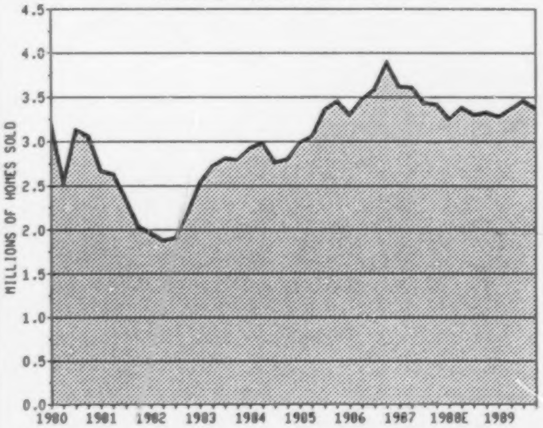
Sean A. Burns
Research Economist
Forecasting & Policy Analysis Division

GRAPH 10: NEW HOME SALES



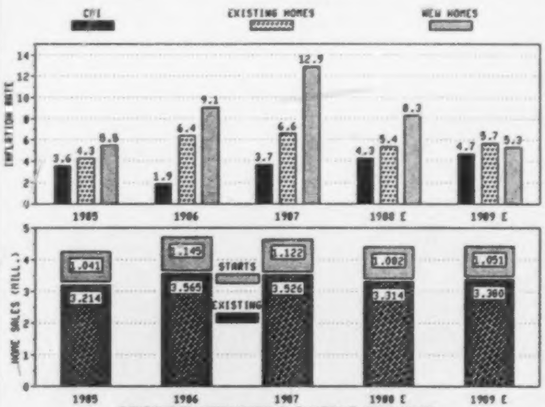
SOURCE: BUREAU OF CENSUS; E - NAR FORECAST.

GRAPH 11: EXISTING SINGLE-FAMILY HOME SALES
(Seasonally Adjusted Annual Rates)



SOURCE: NAR ECONOMICS & RESEARCH, E - NAR FORECASTING & POLICY

GRAPH 12: HOMES ARE APPRECIATING IN REAL TERMS...



...DESPITE WEAKER HOUSING DEMAND

NOTE: New home total equals 97% of single-family starts.

U.S. ECONOMIC OUTLOOK

MAY 1988

	QUARTERS							YEARS			
	Actual		Forecast					Actual		Forecast	
	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1986	1987	1988	1989
AGGREGATE ECONOMY											
Gross National Product (billions of dollars)	4607	4661	4726	4801	4873	4953	5038	4235	4486	4765	5085
% Change	7.6	4.7	5.7	6.5	6.2	6.7	7.0	5.6	5.9	6.2	6.7
% Change (w/out inflation)	4.8	2.3	2.5	3.0	2.6	2.9	3.1	2.9	2.9	2.9	2.7
Consumer Price Inflation (CPI)	3.6	4.2	4.0	4.4	4.5	4.7	4.7	1.9	3.7	4.3	4.7
GNP Inflation (GNP Deflator)	2.7	2.4	3.2	3.5	3.6	3.8	3.9	2.6	3.0	3.2	3.9
Unemployment Rate - Civilian	5.9	5.6	5.7	5.8	5.9	5.9	5.9	7.0	6.2	5.8	5.9
Civilian Employment-Household Basis (millions)	113.5	114.2	114.7	115.1	115.6	115.9	116.2	109.6	112.4	114.9	116.6
Percent change	2.3	2.5	1.8	1.4	1.7	1.0	1.7	2.3	2.6	2.2	1.6
Index of Industrial Production	133.0	134.5	135.4	136.4	137.2	137.9	138.7	125.1	129.8	135.9	138.9
Manufacturing Capacity Utilization	82.2	82.4	82.6	82.8	82.8	83.0	83.2	79.7	81.0	82.7	83.1
Domestic Auto Sales	6.7	7.6	6.9	7.1	6.3	6.9	6.8	8.2	7.1	7.0	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	20.1	20.2	20.1	20.3	20.6	20.6	19.5	20.4	20.2	20.6
Federal Expenditures (NIPA) as % of GNP	24.0	23.9	23.7	23.6	23.6	23.4	23.3	24.4	23.8	23.7	23.3
Deficit (NIPA)	-165.9	-175.0	-164.5	-165.0	-161.2	-137.7	-133.2	-204.7	-152.8	-166.4	-134.7
as % of GNP	-3.6	-3.8	-3.5	-3.5	-3.3	-2.8	-2.7	-4.8	-3.4	-3.5	-2.7
REAL ESTATE MARKETS											
HOME SALES											
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4467	4319	4525	4393	4344	4328	4429	4717	4649	4395	4314
Percent change -- year ago	-10.9	-10.9	-4.5	-3.5	-2.8	0.2	-2.1	10.9	-1.4	-5.5	0.8
Existing Single-family Home Sales ($1000)	3420	3250	3380	3300	3325	3280	3365	3565	3526	3314	3380
Percent change -- year ago	-12.1	-10.7	-7.1	-3.8	-2.8	0.9	-0.4	10.9	-1.1	-6.0	2.0
Housing Starts (thousands)	1533	1480	1590	1556	1493	1541	1549	1805	1634	1529	1546
Percent change -- year ago	-10.7	-16.8	-1.0	-3.9	-2.6	6.3	1.7	3.6	-9.8	-7.8	2.6
Single-Family Units	1090	1102	1180	1127	1050	1081	1097	1179	1157	1115	1084
Percent change -- year ago	-6.2	-11.5	3.8	-2.3	-3.6	2.1	-0.9	10.0	-1.9	-3.6	-2.8
Multi-Family Units	443	377	410	429	443	460	451	631	477	415	462
2-4 Family Units	56	56	58	55	58	59	57	84	66	57	59
Percent change -- year ago	-35.3	-29.1	-19.5	-1.5	2.0	17.5	8.7	-10.1	-21.2	-13.9	3.9
5+ Family Units	387	321	352	374	385	401	394	542	412	358	403
Percent change -- year ago	-17.3	-29.3	-11.2	-8.6	-0.4	17.5	8.7	-5.9	-25.1	-13.0	12.
New Single-family Home Sales (thousands)	635	612	643	659	665	664	697	750	671	639	687
Percent change -- year ago	-10.7	-15.7	-4.3	-0.6	4.7	5.9	8.4	9.0	-10.1	-4.7	7.5
Mobile Homes Shipped (thousands)	232	210	225	241	245	246	249	249	233	230	249
HOME PRICES											
Existing Home Prices - Median ($1000)	84.4	88.1	89.8	90.6	92.5	93.4	94.0	80.3	85.6	90.3	95.4
Percent change -- year ago	5.2	4.5	5.5	6.0	9.6	7.6	7.7	6.4	6.6	5.4	5.7
New Home Prices - Median ($1000)	110.6	109.7	111.5	114.2	115.3	116.0	118.4	92.0	104.0	112.7	119.5
Percent change -- year ago	16.3	12.7	7.7	7.0	3.7	2.2	4.7	9.1	12.9	8.3	5.3
FINANCIAL MARKETS											
Long-Term Interest Rates											
30-yr FRM (FHA Secondary)	10.8	10.1	10.4	10.6	10.7	10.8	11.0	9.9	10.2	10.5	11.0
1-year ARM (without buydown)	8.2	7.5	7.3	7.3	7.5	7.7	8.0	7.9	8.2	7.4	8.0
Corporate AAA Bond Rate	10.2	9.6	9.8	9.9	10.1	10.2	10.4	9.0	9.4	9.9	10.4
Government Bond Rate	9.2	8.6	8.8	9.1	9.1	9.3	9.5	7.8	8.6	8.9	9.5
Short-Term Interest Rates											
Federal Funds Rate	6.9	6.7	6.9	7.1	7.2	7.3	7.4	6.8	6.7	7.0	7.4
3-month T-Bill Rate	5.9	5.8	6.0	6.2	6.3	6.5	6.6	6.0	5.8	6.1	6.5
Prime Rate	8.9	8.6	8.6	8.8	8.8	8.9	9.0	9.2	8.6	8.9	9.5
Discount Rate	6.0	6.0	6.0	6.0	6.0	6.2	6.4	6.3	5.7	6.0	6.3
Value of the U.S. Dollar (Trade-Weighted Avg.)	92.3	90.0	88.0	86.5	85.4	84.7	83.8	112.3	96.9	87.5	82.7
Percent change	-13.8	-9.9	-9.3	-12.4	-7.5	-5.9	-4.8	-21.6	-13.6	-9.7	-5.5

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

TRENDS IN HOUSING AND URBAN DEVELOPMENT OUTLAYS AND BUDGET AUTHORITY

by
Frederick E. Flick
Division Vice President
Forecasting and Policy Analysis

Analyzing the Proposed Housing Budget

Last month we presented a big-picture look at the Administration's proposed budget outlays for Fiscal Years 1988 through 1991. In this analysis we will examine the proposed FY 1989 budget of the U.S. Department of Housing and Urban Development and focus on the trends in housing and community development program authority and outlays since 1976. We will analyze this by comparing some time trend data on various function and agency outlays.

Over the past decade, the HUD budget has suffered substantial cuts in program outlays and spending authority. Many analysts are now concluding that the effects of these cuts are showing up in the current problems of homelessness, high rent costs, and ultimately will affect the affordability of owner-occupied housing.

Proposed HUD Authority/Outlays in the FY 1989 Budget

Commerce and Housing Credit

The Commerce and Housing Credit function covers the HUD programs of the Government National Mortgage Association (GNMA), Federal Housing Administration (FHA), and housing for the elderly and handicapped.

- For GNMA in 1988, guarantees are expected to be issued on $83.4 billion in securities; and for 1989, the Administration proposes a new commitment limit of $100 billion, with new guarantee estimates of $83.6 billion.
- Housing for the Elderly and Handicapped. Currently, HUD makes direct loans to non-profit sponsors to finance the construction of housing for low-income elderly or handicapped residents. For 1988, the Congress has appropriated $566 million in direct loan authority, an amount estimated to be sufficient to finance the construction of over 11,000 units. The President has proposed funding of $350 million for 1989 to assist about 6,800 units. This level of assistance is projected for each year through 1993.

Community and Regional Development

The Community and Regional Development function includes the HUD programs of Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, and Rental Housing Development Grants. The major budget proposals are:

- Community Development Block Grants. The Administration would reduce funding authority from the 1988 appropriation of $2.88 billion to $2.63 billion annually through 1993. However, outlays are still expected to be about $3 billion through 1990. Specific programs that would be terminated include Sec. 108 guaranteed loans and Sec. 312 rehabilitation loans.
- Urban Development Action Grants (UDAG). The UDAG program is slated to terminate at the end of 1989 with a $50 million rescission (reduction) in recaptured funds proposed in FY 1989. However, outlays in FY 1989 are expected to total $366 million due to the spendout of funds for projects approved in prior years.
- Rental Rehabilitation Grants (RRG). The Administration is proposing $150 million in new budget authority for 1989 and the two following years. This figure is down from the $200 million approved for FY 1988. Outlays in 1989 are estimated to be $238 million. The RRG program provides financial incentives to building owners to rehabilitate rental property for low-income families.
- Rental Housing Development Grants (HoDAGs). The program was created in 1983 to subsidize the construction or substantial rehabilitation of rental housing in low- and moderate-income neighborhoods with rental housing shortages. The 1987 Housing and Community Development Act calls for its termination at the end of FY 1989 and the Administration is proposing no further funding. Outlays in 1989 are estimated to be $109 million due to continuing payout on grants awarded in previous years. Those grants will not expire until 1991.

Income Security

The Housing Assistance subfunction under the Income Security function provides housing subsidies for low-income families and individuals through several HUD programs. Eligibility for HUD assistance generally is limited to households with annual incomes below 50 percent of median income in each community. Specific Administration FY 1989 housing proposals include:

- A requested $8 billion in budget authority for 1989 to fund the low-income rental assistance programs. It proposes to provide five-year vouchers rather than fifteen- to twenty-year rental assistance contracts.

- One billion dollars in budget authority for modernizing public housing and $1.5 billion of operating subsidies for the almost 1.4 million public and Indian housing units.
- Funding the supportive housing demonstration for the homeless at $75 million in 1989 with all funds going to transitional housing where the homeless may live for up to 18 months.
- Approximately $50 million in new loan authority for projects for the mentally ill homeless under the Section 202/8 (includes Sec. 8 rent subsidies) program (new housing for the elderly and the handicapped).

Budget Outlay Trends

As part of the annual budget, a set of tables with data on authorized amounts and outlays since 1976 is published for both budget function categories and individual agencies.* Since the great bulk of housing and community development programs are in the HUD budget, we will focus on the historical trend in HUD outlays, relative to those of other agencies.

In 1976, total federal government outlays were $371.8 billion. Military Defense accounted for $88 billion; Health and Human Services (including Social Security) was $120.2 billion; Treasury expenditures were $44 billion; and Agriculture, Labor and Veterans Administration (VA) outlays ranged from $17-$25 billion. The HUD budget was $7.0 billion or 2 percent of total outlays.

By 1980, Federal budget outlays totalled $590.9 billion with the following distribution (in billions) to selected departments: $130.9 - Military Defense; $194.2 - Health and Human Services (including Social Security); $76.5 - Treasury; Agriculture, Labor, and VA ranging from $21 to $35. HUD outlays were $12.7 billion, still averaging about 2.2 percent of the federal budget.

By 1987, the U.S. budget was $1.005 trillion, with the following outlays (in billions) for selected departments: $274 - Military Defense; $351.3 - Health and Human Services (including Social Security); $180.3 - Treasury; and $23-$50 for Labor, Transportation and Agriculture. The HUD outlay budget was $15.5 billion, but its share had dropped to 1.5 percent of total outlays. Under the Administration's current proposal, by 1989, HUD outlays would increase to 1.8 percent for 1988, then move to 2.0 percent through 1990.

Budget Authority Trends

HUD outlays have been a relatively small part of the overall federal budget -- less than the Agriculture, Labor, VA, Transportation, and Education Departments. While HUD outlays as a percent of total outlays have experienced only a small decline since 1976, HUD has suffered the greatest declines in authority for future funding of existing programs or new programs.

In 1976, the total U.S. Government budget authority was $420.3 billion (outlays were $371.8 billion) and HUD authority was $29.2 billion. By 1980, HUD authority was $35.9 billion of a total $676.7 billion. By 1987 HUD authority had dropped to $14.7 billion while total budget authority had increased to $1.099 trillion.

Over the period 1976-1987 Military Defense authority increased from 22.7 percent to 25.4 percent of total authority, and reached as high as 27 percent in 1984. It is proposed to drop to 23.6 percent in 1989. Authority for Health and Human Services (including Social Security) has been as low as 28 percent of total authority. However, it climbed to 34 percent by 1987 and is projected to rise to 37 and 38 percent by 1989-1990.

Cuts in the HUD Budget

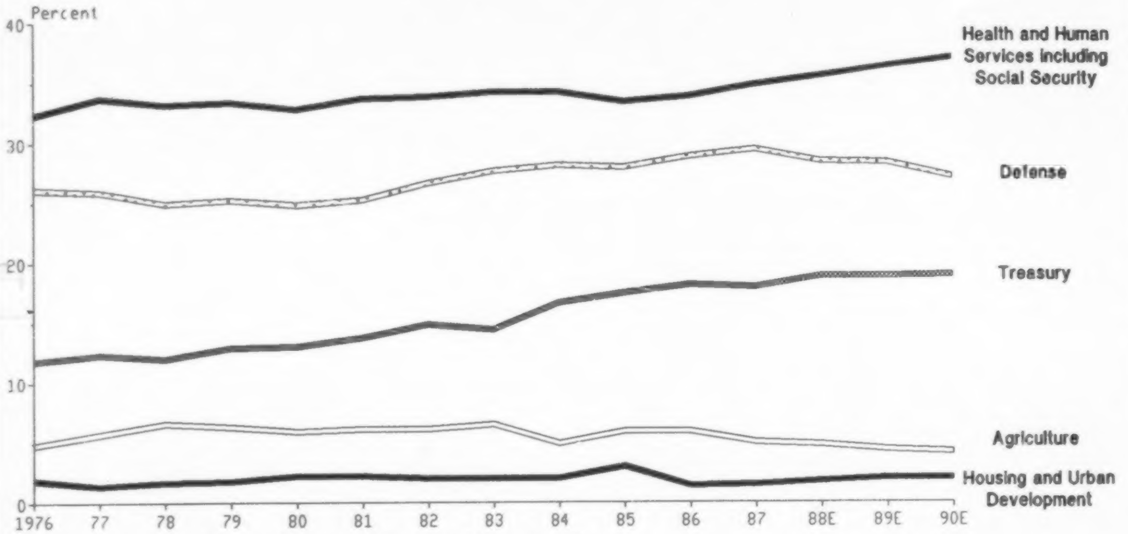
HUD authority, as a percent of total authority has been severely cut over these periods. In 1976 it was 6.9 percent of all authority and rose to 7 percent in 1977-1978. However, since 1980-1981 it has been steadily dropping so that now it has stabilized at about 1.3 percent of total budget authority. The largest cuts have been in the subsidized housing programs, especially those providing long-term rental subsidy contracts for low- to moderate-income tenants.

The substantial cuts in these programs, no doubt have exacerbated the affordability problem for renters and probably have contributed to the homelessness problem. HUD programs providing subsidies for maintaining public housing have also been cut as well as housing development and community development grants for localities.

*Historical Tables, Budget of the United States Government, Fiscal Year 1989, Executive Office of the President, Office of Management and Budget, (U.S. GPO, Washington, D.C.)

PERCENTAGE OF BUDGET OUTLAYS: FY1976-FY1990

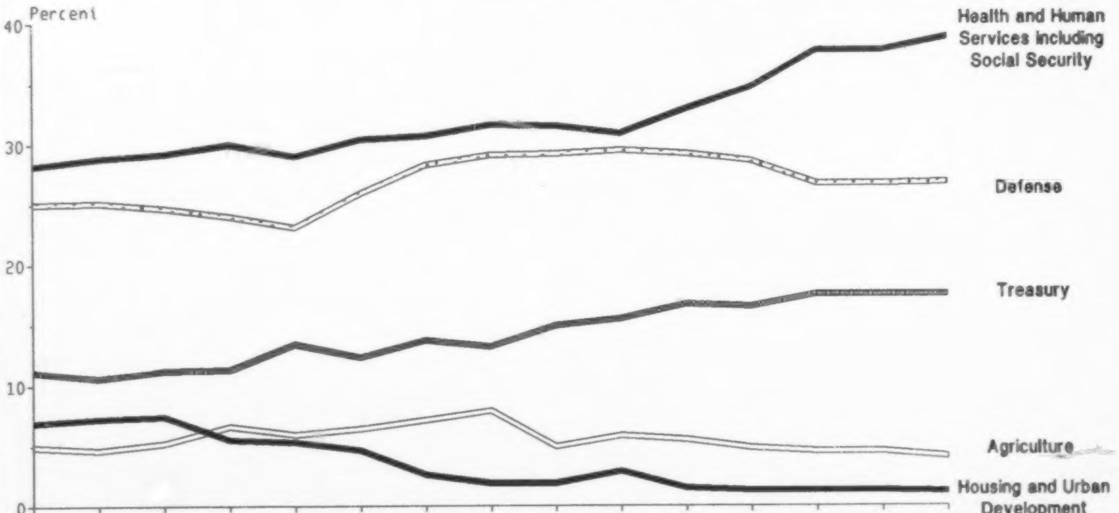
SELECTED U.S. DEPARTMENTS



Source: Historical Tables, Budget of the U.S. Government,Fiscal Year 1989, Office of Managemaent and Budget.

PERCENTAGE OF BUDGET AUTHORITY: FY1976-FY1990

SELECTED U.S. DEPARTMENTS



Source: Historical Tables, Budget of the U.S. Government, Fiscal Year 1989, Office of Management and Budget.

BUDGET OUTLAYS AND PERCENT OF TOTAL BY AGENCY: SELECTED FISCAL YEARS

(dollars in billions)

									Proposed					
	1976		1980		1984		1987		1988		1989		1990	
Department or other unit	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Legislative Branch	0.94	0.2	1.32	0.2	1.78	0.2	1.88	0.2	1.91	0.2	2.12	0.2	2.18	0.2
The Judiciary	0.35	0.1	0.61	0.1	0.9	0.1	1.27	0.1	1.34	0.1	1.73	0.1	1.8	0.1
Executive Office of the President	0.07	0.0	0.1	0.0	0.11	0.0	0.12	0.0	0.13	0.0	0.13	0.0	0.13	0.0
Funds Appropriated to The President	10.93	2.6	-0.73	2.0	18.95	2.0	13.0	1.2	10.47	0.9	10.63	0.9	11.14	0.9
Agriculture	20.76	4.9	39.63	5.9	46.82	4.9	52.52	4.8	59.87	4.5	55.49	4.5	53.54	4.1
Commerce	1.73	0.4	2.61	0.4	2.02	0.2	2.16	0.2	2.42	0.2	2.41	0.2	3.16	0.2
Defense-Military	95.50	22.7	140.65	22.7	258.18	27.2	281.44	25.4	283.16	23.6	290.78	23.6	307.29	23.7
Defense-Civil	9.52	2.3	15.24	2.3	19.23	2.0	35.14	3.2	36.89	3.1	38.46	3.1	40.37	3.1
Education	9.38	2.2	15.29	2.3	15.42	1.6	19.61	1.8	20.26	2.0	24.21	2.0	23.69	1.8
Energy	4.95	1.2	10.03	1.5	10.95	1.2	10.13	0.9	10.76	1.0	12.53	1.0	14.01	1.1
Health and Human Services (except Social Security)	48.21	11.5	78.86	11.7	128.0	13.5	159.7	214.5	176.7	315.5	191.4	215.5	203.2	915.6
Health and Human Services (social security)	70.16	16.7	116.75	17.3	171.43	18.0	221.99	20.2	251.47	22.2	273.34	22.2	301.33	23.2
Housing and Urban Development	29.2	6.9	35.85	5.3	18.15	1.9	14.66	1.3	15.41	1.3	16.15	1.3	16.04	1.2
Interior	2.74	0.7	4.68	0.7	4.91	0.5	5.28	0.5	5.44	0.4	4.79	0.4	2.67	0.2
Justice	2.18	0.5	2.47	0.4	3.46	0.4	5.21	0.5	5.38	0.5	6.16	0.5	6.19	0.5
Labor	20.46	4.9	28.8	4.3	34.83	3.7	30.25	2.8	31.47	2.6	31.71	2.6	30.54	2.4
State	.94	0.2	2.14	0.3	2.98	0.3	3.77	0.3	3.74	0.3	3.84	0.3	4.16	0.3
Transportation	11.08	2.6	19.96	3.0	28.60	3.0	26.12	2.4	27.08	2.1	26.09	2.1	26.60	2.0
Treasury	46.63	11.1	90.51	13.4	141.64	14.9	181.86	16.5	198.97	17.5	215.75	17.5	227.40	17.5
Environmental Protection Agency	0.77	0.2	4.67	0.7	4.06	0.4	5.34	0.5	4.96	0.4	4.68	0.4	4.61	0.4
General Services Administration	0.28	0.1	0.29	0.1	0.25	0.0	0.28	0.0	-0.01	0.0	0.03	0.0	0.03	0.0
National Aeronautics and Space Administration	3.55	0.8	5.35	0.8	7.46	0.8	10.92	1.0	8.93	0.9	11.49	0.9	13.35	1.0
Office of Personnel Management	13.56	3.2	24.92	3.7	37.7	4.0	44.78	4.1	47.68	4.1	50.46	4.1	53.43	4.1
Small Business Administration	0.62	0.1	2.15	0.3	0.97	0.1	0.6	0.1	0.48	0.1	0.78	0.1	0.81	0.1
Veterans Administration	19.65	4.1	21.18	3.1	26.48	2.8	27.36	2.5	28.13	2.4	30.1	2.4	30.88	2.4
Other Independent Agencies	18.28	4.3	31.22	4.6	17.0	1.8	18.79	1.7	20.34	1.4	17.79	1.4	17.31	1.3
Undistributed Offsetting Receipts	-22.17	-5.3	-31.99	-4.7	-52.33	-5.5	-72.31	-6.6	-77.72	-7.3	-89.86	-7.3	-97.83	-7.5
Total Outlays	420.25	100.0	676.70	100.0	949.9	100.0	1099.89	100.0	1175.69	100.0	1233.15	100.0	1299.05	100.0

Source: Historical Tables, Budget of the U.S. Government, Fiscal Year 1989, Executive Office of the President, Office of Management and Budget, (U.S. GPO, Washington, D.C.).

BUDGET AUTHORITY AND PERCENT OF TOTAL BY AGENCY: SELECTED FISCAL YEARS

(dollars in billions)

	1976		1980		1984		1987		Proposed					
									1988		1989		1990	
Department or other unit	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Legislative Branch	0.94	0.2	1.32	0.2	1.78	0.2	1.88	0.2	1.91	0.2	2.12	0.2	2.18	0.2
The Judiciary	0.35	0.1	0.61	0.1	0.9	0.1	1.27	0.1	1.34	0.1	1.73	0.1	1.8	0.1
Executive Office of the President	0.07	0.0	0.1	0.0	0.11	0.0	0.12	0.0	0.13	0.0	0.13	0.0	0.13	0.0
Funds Appropriated to The President	10.93	2.6	-0.73	2.0	18.95	2.0	13.0	1.2	10.47	0.9	10.63	0.9	11.14	0.9
Agriculture	20.76	4.9	39.63	5.9	46.82	4.9	52.52	4.8	59.87	4.5	55.49	4.5	53.54	4.1
Commerce	1.73	0.4	2.61	0.4	2.02	0.2	2.16	0.2	2.42	0.2	2.41	0.2	3.16	0.2
Defense-Military	95.50	22.7	140.65	22.7	258.18	27.2	281.44	25.4	283.16	23.6	290.78	23.6	307.29	23.7
Defense-Civil	9.52	2.3	15.24	2.3	19.23	2.0	35.14	3.2	36.89	3.1	38.46	3.1	40.37	3.1
Education	9.38	2.2	15.29	2.3	15.42	1.6	19.61	1.8	20.26	2.0	24.21	2.0	23.69	1.8
Energy	4.95	1.2	10.03	1.5	10.95	1.2	10.13	0.9	10.76	1.0	12.53	1.0	14.01	1.1
Health and Human Services (except Social Security)	48.21	11.5	78.86	11.7	128.0	13.5	159.7	214.5	176.7	315.5	191.4	215.5	203.2	915.6
Health and Human Services (social security)	70.16	16.7	116.75	17.3	171.43	18.0	221.99	20.2	251.47	22.2	273.34	22.2	301.33	23.2
Housing and Urban Development	29.2	6.9	35.85	5.3	18.15	1.9	14.66	1.3	15.41	1.3	16.15	1.3	16.04	1.2
Interior	2.74	0.7	4.68	0.7	4.91	0.5	5.28	0.5	5.44	0.4	4.79	0.4	2.67	0.2
Justice	2.18	0.5	2.47	0.4	3.46	0.4	5.21	0.5	5.38	0.5	6.16	0.5	6.19	0.5
Labor	20.46	4.9	28.8	4.3	34.83	3.7	30.25	2.8	31.47	2.6	31.71	2.6	30.54	2.4
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Other Independent Agencies	18.28	4.3	31.22	4.6	17.0	1.8	18.79	1.7	20.34	1.4	17.79	1.4	17.31	1.3
Undistributed Offsetting Receipts	-22.17	-5.3	-31.99	-4.7	-52.33	-5.5	-72.31	-6.6	-77.72	-7.3	-89.86	-7.3	-97.83	-7.5
Total Authority	420.25	100.0	676.70	100.0	949.9	100.0	1099.89	100.0	1175.69	100.0	1233.15	100.0	1299.05	100.0

Source: Historical Tables, Budget of the U.S. Government, Fiscal Year 1989, Executive Office of the President, Office of Management and Budget, (U.S. GPO, Washington, D.C.).

A Real Estate Profile: First-Time Homebuyers in the Spring 1988 Marketplace

More than one-third (38 percent) of homes purchased this Spring were bought by first-time homebuyers, according to the most recent Residential Mortgage Finance Panel Survey conducted by the Real Estate and Finance Division of the NATIONAL ASSOCIATION OF REALTORS®. The survey, whose results will be released early this month in *The Home Financing Transaction: Spring 1988* report, found that these new property owners exhibited dramatically different financial and household characteristics from repeat homebuyers.

The Spring 1988 survey results, which reflect mortgage activity from mid-March to mid-April, were reported by a panel of expert residential real estate brokers who are members of the NATIONAL ASSOCIATION OF REALTORS®. These brokers report information three times each year to provide the only publicly available information on the specific techniques, instruments, and sources of financing used to purchase residential property. Characteristics of the buyer and the property are also reported. Highlights of the Spring 1988 survey are presented below.

SPRING 1988 HIGHLIGHTS

Financial Characteristics

The average first-time homebuyer paid $84,100 for a home with a first mortgage amount of $74,100 for an average LTV of 90.50 percent. In contrast, repeat homebuyers bought substantially more expensive homes with proportionally larger downpayments. The repeat buyer paid an average of $126,900 on a home with a $93,700 first mortgage, an average LTV of 77.39 percent.

First-time homebuyers were charged a slightly higher average mortgage interest rate this Spring than were repeat homebuyers -- 9.46 percent compared to 9.22 percent. This reflects the fact that first-time homebuyers were much more likely to use a fixed-rate mortgage (FRM) to finance their purchase than were repeat homebuyers. In fact, 73 percent of first-time homebuyers used a FRM to finance their home purchase, and only 24 percent using an ARM. In contrast, 62 percent of repeat homebuyers used an FRM, while 35 percent financed their home with an ARM.

Mortgage Insurance

The largest segment of first-time homebuyers used FHA insurance to insure their first mortgage. Specifically, 35 percent of first-time homebuyers used FHA insurance, 18 percent used a VA guarantee, and 21 percent used private mortgage insurance. State bonding agencies and other sources of mortgage insurance accounted for 2 percent of transactions. Less than one-quarter, or 23 percent, of first mortgages did not require mortgage insurance.

In contrast, close to two-thirds of repeat homebuyers did not use mortgage insurance. FHA insured 11 percent of first mortgages, and VA guaranteed only 5 percent of first mortgages for these buyers. The most popular source of mortgage insurance with repeat buyers was private mortgage insurance, which accounted for 21 percent of the transactions.

Household Characteristics

Three out of ten first-time homebuyers were singles -- 16 percent single males and 14 percent single females, with unmarried couples accounting for an additional 8 percent. A full 61 percent of first-time homebuyers were married couples. By contrast, 79 percent of repeat homebuyers were married, with only 8 percent single males and 11 percent single females.

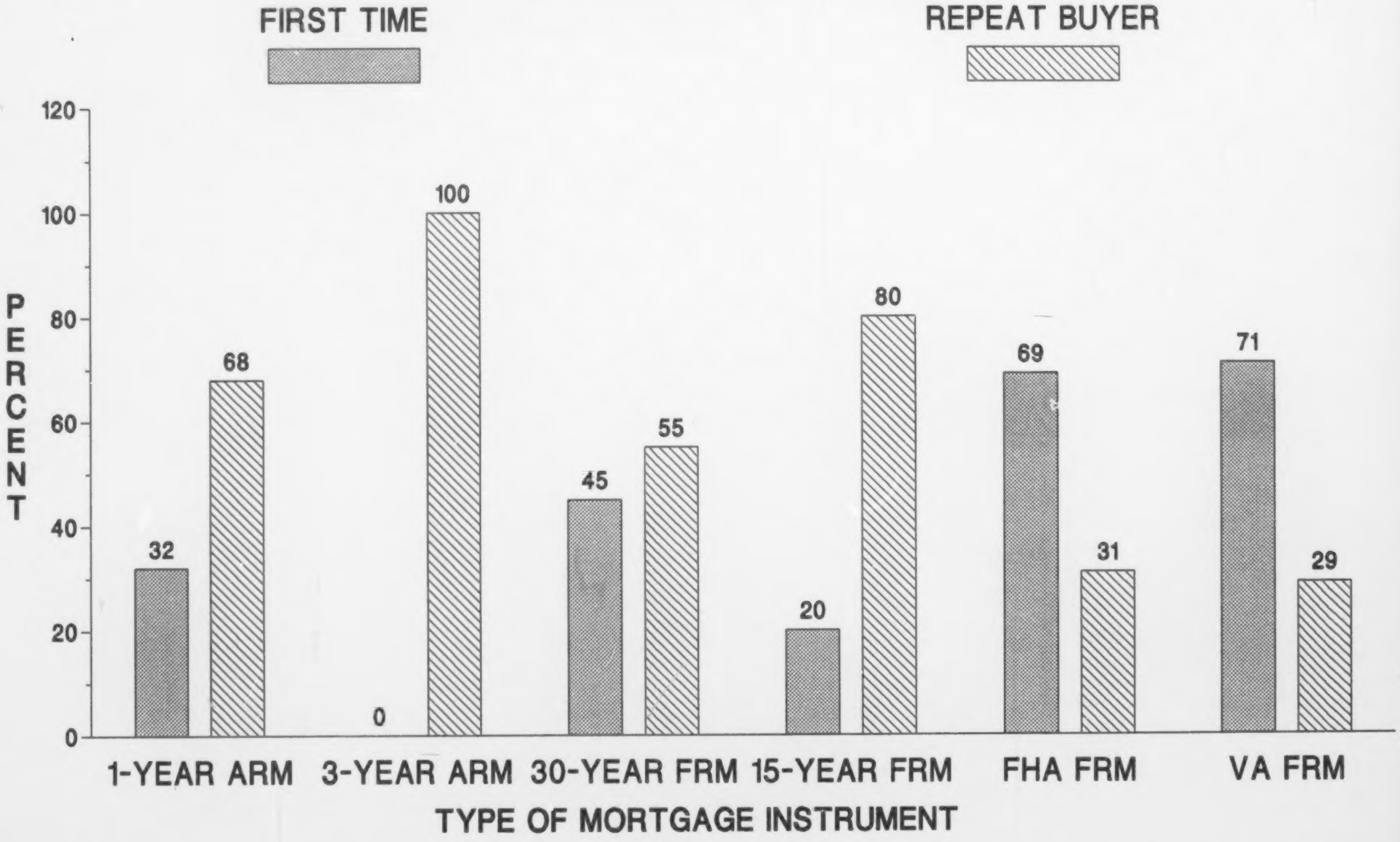
Not surprisingly, 80 percent of first-time homebuyers were just changing residences within the metropolitan area. Of the 20 percent of the first-time homebuyers new to the area, half were as a result of corporate relocation.

Just 54 percent of repeat homebuyers were changing residences in the metro area, and 33 percent were new to the area, 22 percent due to corporate relocation. An additional 11 percent of repeat homebuyers were reported to have bought their current purchases for investment purposes.

The median income of the first-time homebuyer during Spring 1988 was $35,700. Repeat homebuyers had a substantially larger median income of $50,000.

Repeat buyers were almost a full 10 years older than first-time buyers. The median age of the first-time homebuyer was 29.3 years, compared to 39.0 years for repeat homebuyers.

CHARACTERISTICS OF THE BUYER SPRING 1988
FIRST TIME VERSUS REPEAT HOMEBUYERS



SIOR PUBLISHES INDUSTRIAL AND OFFICE GUIDE

The Society of Industrial and Office REALTORS® (SIOR) recently published the *1988 Guide to Industrial and Office Real Estate Markets*. The publication includes reviews of industrial real estate in 105 metropolitan markets and office real estate in 97 metropolitan markets. The 270 page document also includes a 1987 review and 1988 forecast of the economy and the real estate industry. This annual research project is a joint effort of SIOR and the Division of Economics and Research of the NATIONAL ASSOCIATION OF REALTORS®.

ISSUES AND TRENDS

In the wake of tax reform and the widespread oversupply of office and industrial space in many metropolitan areas, real estate professionals have come to "focus on the fundamentals." This reevaluation of decision criteria for real estate development and investment does not, however, mean an end to innovation and change within the industry, but transactions will be more carefully scrutinized in 1988.

At this juncture, it appears highly probable that 1988 will be a year of slow growth, moderate inflation, stable interest rates, improving trade balances, and an opportunity to make some headway on the federal budget deficit. Based on these conclusions, 1988 should allow for some progress in many metropolitan areas that are saddled with excess office and industrial space.

It would be disingenuous to forecast progress for all areas, but: 1) the industrial sector of the economy is remarkably strong; 2) interest rates are fairly stable and will move up very little unless inflation escalates unexpectedly; and 3) when a well-located, Class A product is available, there are a lot of investors looking to buy.

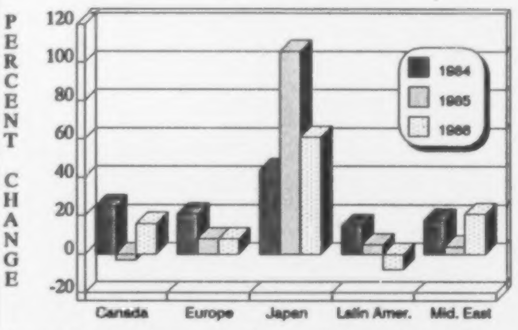
The real estate activities of large institutional investors and foreign investors have become a major preoccupation with the real estate press. While pension funds have over one trillion dollars worth of asssets, only approximately 3.5 percent of their assset mix consists of real estate equity. But even if the share of pension fund assets hasn't changed much, real commitments have increased because of a growing pool of total assets. Institutions are in the market for quality properties but real increases in allocation targets are not expected because the funds cannot find an adequate supply of satisfactory properties and new development is often hard to justify in most markets.

Large institutional investors and foreign investors place a large premium on top quality real estate. There has been only marginal interest in anything but Class A properties in top tier markets. There are signs, however, that fund mangers and offshore investors are taking a hard look at more types of properties and second tier cities. Escalating prices in the popular coastal cities and an apparent resurgence of the industrial belt have led several real estate analysts to suggest diversification decisions will be made on the basis of economic criteria instead of limited geographic criteria. Clearly, smaller markets and quality industrial properties stand to benefit.

Foreign investment continues to be the hottest topic in office and industrial real estate circles. Most observers believe the process of transferring ownership of real property from domestic to foreign owners will continue at a rapid pace. Progress on the budget and trade deficits is real but serious imbalances remain. There will continue to be a large pool of offshore money searching real estate markets for a good return on investment.

Western European and Canadian investors own the largest share of total real estate assets but Japanese investors are increasing their holdings at such a rapid pace that they are the focus of intense public scrutiny right now. Japanese investment grew 233 percent during the three year period between 1984 and 1986. Private estimates of Japanese purchases in 1987 alone range from $6 to $10 billion.

CHANGE IN FOREIGN DIRECT INVESTMENT POSITION IN REAL ESTATE



Source: Dept. of Commerce, Bureau of Economic Analysis

Like institutional investors, foreign investors generally invest in centrally located, top quality buildings. During the past two years, the Japanese have made several purchases of trophy properties, paying record prices and provoking the American public's curiosity about their intentions. They prefer office buildings and resort hotels located primarily in a few coastal cities and Hawaii. Large Japanese insurance and financial corporations have developed business relationships with American companies with expertise in real estate development, finance, acquisition, and management. There is little doubt that the Japanese will continue to agressively aquire real property in the United States.

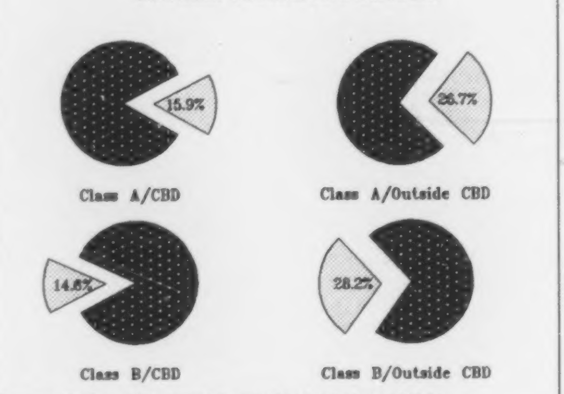
OFFICE MARKETS

Office markets in 1987 were characterized by stabilizing conditions in several weak markets in the Southwest and a strong performance by several vital markets on the coasts and in the Midwest. SIOR panelists in 97 markets provided information on over 2.5 billion square feet of office space.

The overall vacancy rate for the complete inventory of rentable office space nationwide is 21.7 percent. Class

A/Central Business District (CBD) space has a vacancy rate of 15.9 percent. Class A space outside the CBD is 26.7 percent vacant. Class B vacancy rates are 14.6 percent for CBD space and 28.2 percent for space outside the CBD.

OFFICE VACANCY RATES

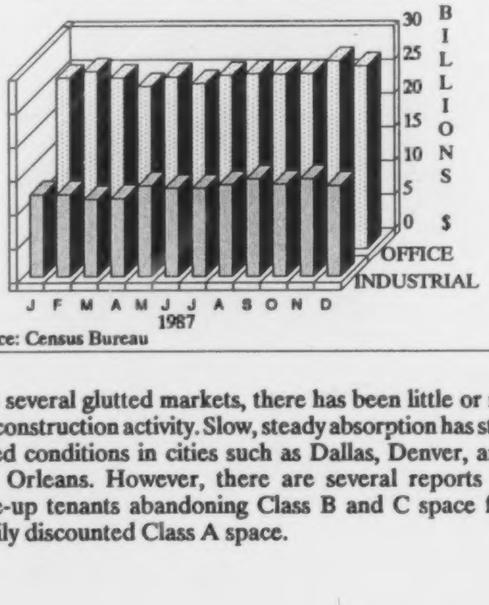


Source: Society of Industrial and Office REALTORS®

Vacancy rates were particularly high in areas that are having to weather local or regional economic distress or, in market areas that have recently experienced a surge in construction activity. Several markets reported comparatively low vacancy rates, led by Albany where only 4.32 percent of Class A space is vacant.

Office construction declined 12.6 percent in 1987 which is a much milder decline than many analysts had predicted. Approximately 175 million square feet of new space was completed in 1987. Most forecasters are still pessimistic about prospects for 1988 and expect the value of new construction to be off anywhere from 15 to 25 percent.

CONSTRUCTION SPENDING
(ANNUAL RATE, SEASONALLY ADJUSTED)



Source: Census Bureau

In several glutted markets, there has been little or no new construction activity. Slow, steady absorption has stabilized conditions in cities such as Dallas, Denver, and New Orleans. However, there are several reports of move-up tenants abandoning Class B and C space for heavily discounted Class A space.

Absorption was especially strong in the Northern New Jersey and Atlanta markets. The consolidated metropolitan areas of New York City, Los Angeles, and Washington, D.C. have been perennial absorption leaders the past few years and that held true for 1987.

Demand for office space will depend, of course, on the growth of employment in office-intensive industries. Most studies of office employment suggest that growth will continue in 1988 but at a slower pace. One of the often overshadowed impacts of the stock market adjustment was the effect it has had on employment in financial services. Employment growth generated by the success of Wall Street firms during the current expansion has most likely ended.

A majority of SIOR panelists expect 1988 to be a year of stability and slow recovery in their office markets. Nationwide, absorption will increase by less than five percent and rental rates will be flat. Over 40 percent of panelists expect vacancy rates to fall, due in part to declining construction activity. But areas with large concentrations of financial services employment could be adversely affected by a contraction in that office-intensive industry.

INDUSTRIAL MARKETS

The technical signals on the industrial market are very positive and 1988 should be a strong year. Between 30 and 40 percent of the panelists in 105 markets surveyed by SIOR report moderate or substantial shortages of space in one or more building-size categories (Seven categories encompassing less than 5,000 sq. ft. to more than 100,000 sq. ft.).

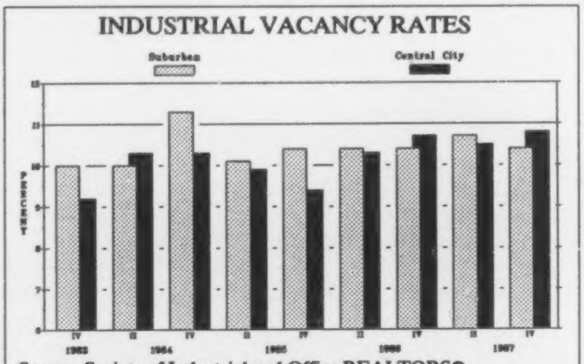
The heightened prospects for increases in net exports coupled with increasing business investment in equipment bodes well for industrial property demand. Markets on the coasts where trade flows are a significant factor will continue to experience escalating property values and strong demand. This year, however, with the renewel of America's basic industries and renewed strength in the computer and electronics industries, the prospects for vital market conditions are more broad-based.

SIOR panelists in cities such as Minneapolis, Cincinnati, and St. Louis report a significant increase in activity. The beleaguered high technology component of the industrial market will remain immensely oversupplied, but 1988 will bring positive absorption in that sector, allowing vacancies to decline.

Despite an overall decline of 7.9 percent in the value of industrial construction in 1987, there were significant increases of new space in several markets. Atlanta added a remarkable 7,483,000 square feet to its inventory in 1987. Construction was also very strong in San Diego, Seattle, and Boston. As has been the case for several years, construction is heavily concentrated in suburban areas.

Strong absorption, especially of warehouse and distribution space, was widespread in 1987. The rapidly growing market of Los Angeles–San Fernando recorded approximately five million square feet of absorption. Other markets with strong absorption include Boston, San Diego, Cincinnati, Minneapolis/St. Paul, Atlanta, and Los Angeles–East.

The SIOR vacancy rate for centrally located industrial buildings increased 0.3 percent to 10.7 percent during the first half of 1987 before sliding back down to 10.4 percent in the fourth quarter. The suburban vacancy index moved up 0.2 percent early in the year to 10.5 percent and then increased another 0.3 percent to finish the year at 10.8 percent.



Source: Society of Industrial and Office REALTORS®

Tight industrial markets are not confined to any geographic area. From Greenville in the South, Reno in the West, and Cincinnati in the Midwest, several areas are experiencing shortages of industrial space.

The SIOR lease price indexes for all building categories except high-tech properties showed steady increases during 1987. Price increases were especially strong during the last half of the year.

Sales prices generally increased moderately early in the year but declined during the third and fourth quarters. Centrally located properties were more adversely affected than suburban properties.

In summary, industrial real estate is poised for another good year in 1988. Manufacturing firms are on the verge of increased space requirements. High-tech space is still oversupplied but high technology industries are experiencing growth again. And warehousing and distribution space demand is still strong. New industrial space can be delivered quickly and the industrial market is, as always, vulnerable to a recession. But a recession this year is unlikely. Instead, export-led growth will stimulate manufacturing and increase demand for industrial real estate products and services.

John R. Beckord
Research Economist
Division of Economics and Research

For more information about SIOR or the *Guide to Industrial and Office Real Estate*, contact:
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REAL ESTATE OUTLOOK

Vol. 1, No. 6 *June 1988*

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The annual rate of real GNP growth in the first quarter of 1988 was revised up to 3.9 percent from the preliminary estimate of 2.3 percent. The bulk of the revision came as a result of larger than expected gains in exports. The preliminary GNP report had to rely on incomplete trade data for the month of March. This faster rate of real GNP growth raises concerns over the prospect for accelerating rates of inflation in coming months. The forecast for GNP growth in 1988 has been revised upward to a 3.6 percent rate, measured on a year-over-year basis.
- Accelerating operating rates at U.S. factories in the face of rising domestic and foreign demand, increases in both new and unfilled orders for durable goods, and higher import prices are at the center of the debate about whether inflation will accelerate. Nonpetroleum merchandise import prices rose at an annual rate of 9.6 percent in the first quarter.
- Not all of the news on inflation confirms an accelerating trend. Wages are rising at a surprisingly modest rate so far in 1988. In addition, the overall pace of consumer price inflation reached an annual rate of only 3.4 percent in the first quarter. In 1988, consumer prices are expected to increase at an annual rate of 4.1 percent, measured on a year-over-year basis.
- The recent rise in long-term interest rates has resulted from the concern over faster inflation. Currently, interest rates on fixed-rate mortgages are averaging 10.5 percent, and are expected to move higher during the summer. Mortgage rates could rise past the 11.0 percent level by late this fall. For all of 1988, the secondary mortgage market rate on FHA insured mortgages is expected to average 10.5 percent.
- Existing single-family home sales are currently enjoying a much stronger springtime buying season than previously expected. Existing single-family home sales rose to a seasonally adjusted annual rate of 3.48 million units, 4.5 percent faster than the March annual rate of 3.33 million units. This was the fastest monthly advance in the annual rate since November 1986. The pace of home sales is expected to eventually slow as a result of the rise in mortgage interest rates. Existing single-family home sales are expected to total 3.34 million units in 1988.

IN THIS ISSUE

- **Economic Commentary: BOGSAT, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Secondary Market Outlook, by Mary A. Fruscello**
- **New Tax Rules and Proposed Tax Laws Affecting Real Estate, by Kevin Yeats**

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BOGSAT

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

National policy during the Carter Administration (has it really been *twelve* years?) was often developed through the process of BOGSAT -- a bunch of guys sitting around talking. Sometimes it seems that BOGSAT is now the mode for economic policy: we are pushed and tugged not by sound analysis, but rather by rumor and opinion molded by people who talk mainly with each other.

Take a look at reality. The gross national product for the first quarter expanded at nearly a four percent rate, adjusted for inflation. The root of this growth was a significant expansion of exports, a trend that is now nearly eighteen months old. More importantly, business investment was also a large part of this growth picture. While it's true that inventory pile-up was unusually large, we are still seeing an investment process born of an optimism characterized by a large drop in business failures during the first quarter. Manufacturing productivity is up and, largely as a response to increased demand for exports, so is capacity utilization. Unemployment is at a ten-year low. Sounds like a prosperous economy, doesn't it?

Now, let's examine policy perception. Do our opinion leaders -- the Congress, the press -- see this same pattern and use it as the basis of policy. In the words of John Belushi, NO-O-O-O-O-O! Policy making appears based on an entirely different set of facts, a world where an inflation plague is about to break out, manufacturing has been crushed by a growing service sector and where American goods are so uncompetitive that enormous trade barriers must be thrown up. From these "facts" stem financial market behavior that pushes interest rates up and legislation that could initiate destructive trade wars. This is BOGSAT at its finest. When bond traders talk only to bond traders and Congress listens only to those whose opinions match its own preconceptions, sound economic policy is the victim.

Of course, there is the danger of being too much the Pollyanna. Given the fall in the dollar and the increasing pace of export production, inflation could be a problem. And there is little doubt that the CPI in 1988 will rise more than it did in 1987, while interest rates will drift up through the rest of this year. But three factors ought to keep the economy well within bounds. First, the real strengths described above are a substantial brake on any kind of speculative excess. Second, the current Federal Reserve Board appears to be committed to making small changes quickly to blunt the build-up of inflationary pressures. Finally, the openness of the U.S. economy provides sufficient safety valves to calm excessive price movements.

The net here is that the economy is fundamentally sound. We seem, by some fortuitous confluence of events, to have reinvented the prosperity of the early 1960's. There is at least another year of steam in this expansion. Part of the problem with the dichotomy between reality and policy perception, however, is that we've changed since then. We are more open to the rest of the world and our economy is more service-oriented, and both of these things are frightening to those who can't (or won't) deal with change.

In "The Cherry Orchard," a (very bad) play by Anton Chekhov, the merchant Yermolay Andreyevich Lopakhin buys at auction the cherry orchard which symbolizes the lives and traditions of a dying aristocratic family. He transforms the beloved orchard into summer home lots, destroying the orchard so that (in his words), "it may once more be fruitful." This is an economy which is fruitful, but in a transformed way. It's a change that has been good, but for some, has been hard to accommodate.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

The economy appears to be expanding at a rate much faster than expected in the wake of the stock market crash. The first quarter annual rate of real GNP growth was revised up to an annual rate of 3.9 percent, much higher than the original estimate of 2.3 percent. A modest upward revision had been expected, but not the near doubling of the estimate. This has raised the risk of inflation from an overheating economy. While the aggregate inflation measures are not yet showing these accelerating rates of inflation, some of the underlyiung characteristics of this recent surge in growth suggest faster price increases may be in store. Accelerating operating rates at U.S. factories in the face of rising domestic and foreign demand, shortages in the supply of needed component parts, and higher prices on nonpetroleum merchandise imports are but a few of the emerging trends. The list only lacks a steady rise in wages as the flashpoint for a renewed wage price spiral. From last month, we have revised upward our estimate of real GNP growth for the current quarter from 2.5 percent to 2.9 percent which has also led to upward adjustments in the inflation path, which is expected to average 4.1 percent in 1988 on a year-over-year basis. The forecast has been extended to 1990 with this forecast.

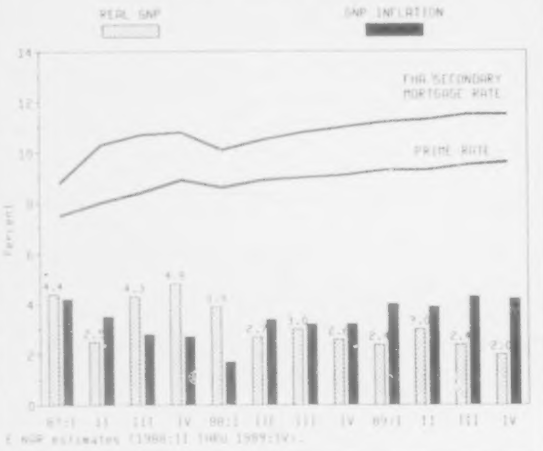
Exports Are Booming

The bulk of the revision in the annual rate of first quarter real GNP growth occurred as a result of huge gains in exports. The preliminary GNP report had relied on incomplete trade data for the month of March. But a full quarter's reporting on the trade data has confirmed the continued surge in U.S. exports. However, much of this external demand for U.S. goods has put pressure on U.S. manufacturers to expand capacity. The response is clear: both the preliminary and revised GNP reports confirm that U.S. manufacturers are re-tooling at a more rapid rate. The steady contribution of the U.S. consumer is another important feature of both GNP reports. This is a positive trend to the extent that U.S. consumers continue to adjust their preferences away from imported goods and in favor of U.S. goods.

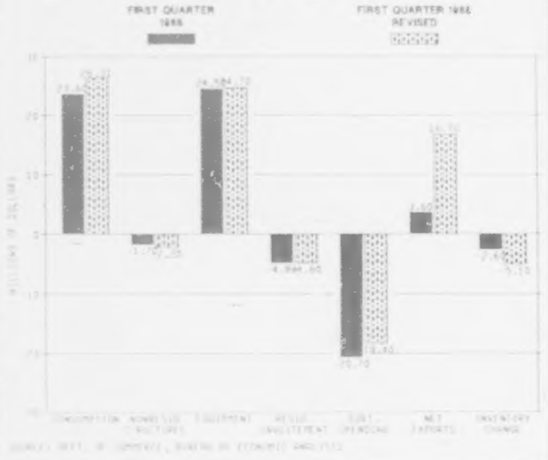
Durable Goods Orders

The news on durable goods orders has also been very good, and again, possibly a bit too good for the economy's short-term inflation prospects. At first glance, the nation's manufacturers of durable goods are in an enviable position: durable goods producers received orders at a rate of $116.3 billion in April, 0.8 percent higher than March, a month in which they rose even faster, by 0.9 percent. The frenzied pace of orders has helped drive the jobless rate at durable goods manufacturers down to 4.8 percent in April. However, all of this heating up could possibly lead to an overheating economy if plant and equipment re-tooling can not keep up with demand. Unfilled orders for durable goods have been rising at an increasing rate, further evidence that businesses are finding it difficult to expand capacity fast enough. The next development could possibly be a bursting of the protective bubble of modest wage settlements so far in the 1980's, which could be followed closely by a faster overall rate of price increases.

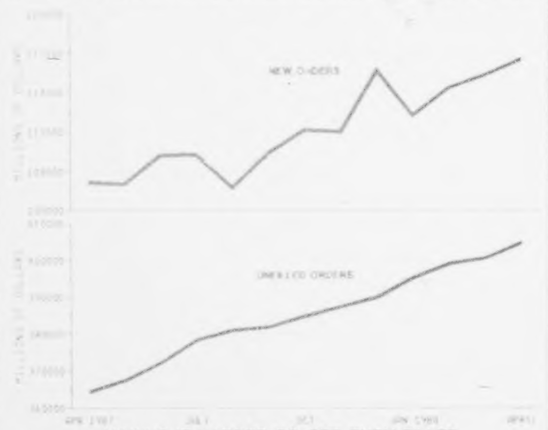
GRAPH 1: THE ECONOMIC OUTLOOK



GRAPH 2: A SURGE IN EXPORTS LEADS TO INCREASED FIRST QUARTER REAL GNP GROWTH



GRAPH 3: ORDERS FOR DURABLE GOODS CONTINUE TO RISE...



...MAKING IT HARDER TO GET THEM FILLED.

SOURCE: CURRENT INDUSTRIAL REPORTS

Inflation Heating Up?

The outlook for inflation, when thought of from the perspective of an overheating economy appears to be one of considerable risks on the upside. Indeed, the arguments commonly used to advance this point are rather convincing. First, domestic producers could be forced to raise prices on their goods in order to keep up with price increases they are encountering on intermediate goods purchased from other capacity-constrained producers. Further, many U.S. manufacturers are bracing for higher wage settlements in 1988 after achieving several years of modest wage advances as part of efforts to improve efficiency. Abroad, foreign producers are showing signs of crying "uncle" and are finally caving in to the lower dollar by raising their prices to American consumers. Evidence of this overdue development showed up in the latest report on import prices. In the first quarter of 1988, prices on non-petroleum merchandise imports rose 9.6 percent. Not only was the magnitude of the price rise disturbing, but the fact that the number excluded the more volatile petroleum products has hammered home the point.

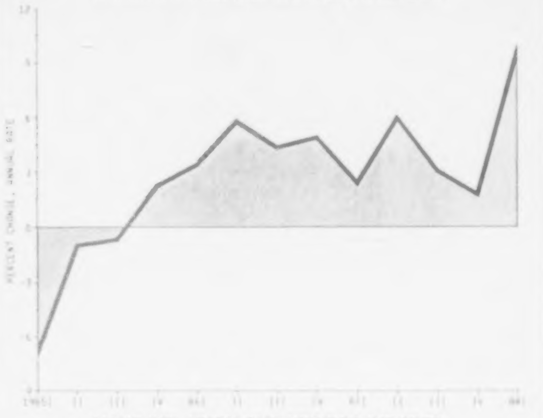
Maybe Not

But the potential for accelerating rates of inflation is tempered by the widespread concern that an economic slowdown is inevitable. Those that share this view say that the soft spots in the economy are beginning to surface, and they include an overextended consumer and a housing industry emerging from two years of record growth (during which more than 7 million existing homes were sold, and nearly 2.0 million new homes were started, in 1986 and 1987). The economy is presently experiencing a rise in interest rates that could dampen the prospects for continued growth later in the year. Also, the annual rate of growth in consumer prices as measured by the Consumer Price Index does not support the notion that the overall rate of price advances has begun to spiral upward. The first quarter's 3.4 percent annual rate of advance in consumer prices reinforces the view that prices are not yet accelerating.

MONETARY POLICY AND INTEREST RATES

The current monetary policy stance of the Federal Reserve Board appears to be one of tightening up in the face of heightened inflation fears. As the graph to the right shows, the yields on instruments of virtually all maturities have risen steadily in the last few months. Hoping to quiet these inflation fears, the Fed has tightened its grip on the money supply and consequently nudged up short-term interest rates. This is evident from the widening gap between the yield curves at the short-term edge. The fact that the Fed has allowed interest rates to rise signals their comfort with the economy's present rate of growth, but not with the expected level of inflation. In the coming months, interest rates on all maturities are expected to rise, pushing the yield curve up even higher. If the Fed's efforts at reducing the fear of inflation are successful, then some flattening of the yield curve may occur.

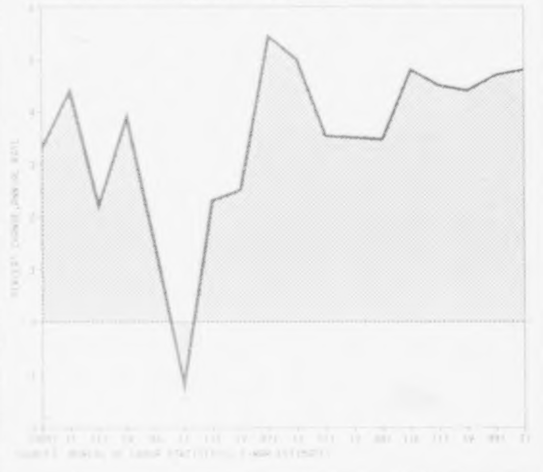
GRAPH 4: WILL RISING IMPORT PRICES...



MAKE INFLATION OUR NEWEST IMPORT?

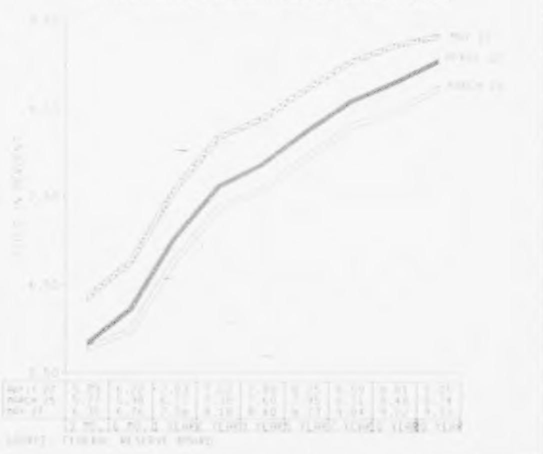
SOURCE: BUREAU OF ECONOMIC ANALYSIS

GRAPH 5: CPI INCREASES REMAIN MODEST



GRAPH 6: THE YIELD CURVE

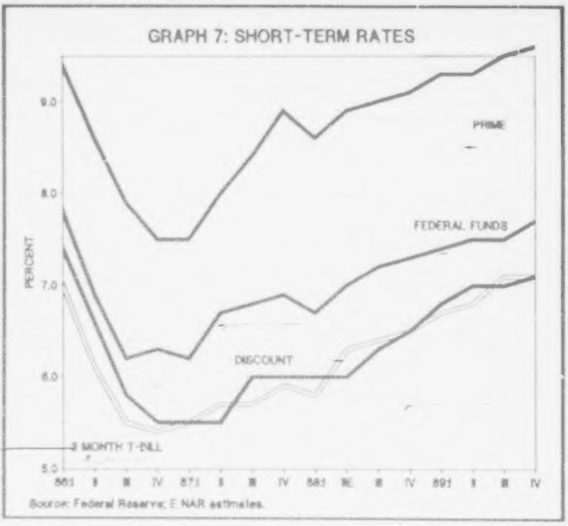
(RATES ARE FOR U.S. TREASURY CONSTANT MATURITY ISSUES)



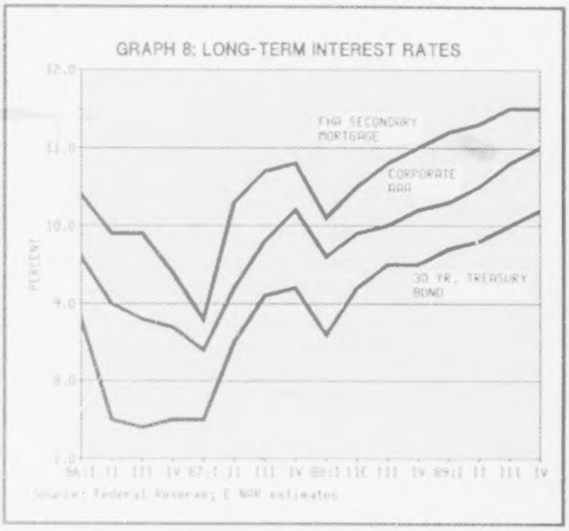
Short and Long-Term Rates Headed Higher

The signs of a resurgence of economic growth from explosive export demand has helped raise interest rates in recent weeks. Financial market players have eyed the faster real GNP growth and falling unemployment rate with increasing concern over what they both might mean for faster rates of inflation. The Fed has already taken action to discourage these inflation fears on at least two occasions so far in 1988. First, after watching the federal funds rate drift lower following the stock market crash in October, the Fed acted in earyl April to move the rate back above the 6.75 percent mark. The second action came on the eve of the quarterly refinancing in early May, when the Fed nudged the rate just above 7 percent. Already, the Fed appears to have tightened a third time, this in respone to the stronger GNP report. Since that report was released, the federal funds rate has been trading at about 7.375 percent. Usually, the federal funds rate and the more visible discount rate move together, with but small gaps between the two rates. For the moment, the Fed seems to be reserving an increase in the discount rate; perhaps as a means of reassuring foreign investors holding dollar-denominated assets in the event of another slide in the dollar. As a result, an unusually large gap has opened between the federal funds rate and the discount rate. This could bring criticism that the Fed is actually pursuing a looser policy than the federal funds rate implies, and that it is subsidizing the borrowing costs of U.S. banks through the lower discount rate. Therefore, the current forecast projects the Fed raising the discount rate by mid-July.

The Fed's actions notwithstanding, expectations of faster inflation have already brought increases in long-term interest rates. The current forecast projects this upward trend to continue through the rest of 1988. The secondary market yield on FHA guaranteed mortgages is expected to average 10.5 percent in the current quarter, rising steadily during the summer to more than 10.75 percent, to reach an annual average of 10.5 percent in 1988.


GRAPH 7: SHORT-TERM RATES

Source: Federal Reserve; E NAR estimates.

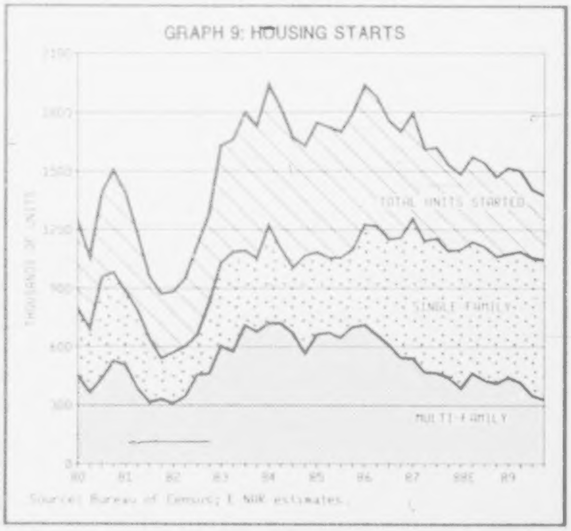

GRAPH 8: LONG-TERM INTEREST RATES

Source: Federal Reserve; E NAR estimates

REAL ESTATE MARKETS

Housing Starts

Privately owned housing units were started at a seasonally adjusted annual rate of 1.561 million units in April, marginally faster than the March annual rate of 1.554 million units. The rise in the April rate was the third consecutive monthly advance in the total starts rate. Single-family units were started at an annual rate of 1.095 million units in April, almost 7 percent slower than the March annual rate of 1.176 million units. The rise in the overall starts rate was based on a 28.7 percent advance in the annual rate of multi-family structures with five or more units. These structures were started at an annual rate of 408 thousand units in April. Multi-familly structures with 2-4 units were started in April at an annual rate of 58 thousand units, off 5 percent from the March pace of 61 thousand units. These starts figures demonstrate that considerable strength remains in the housing industry. However, the softness in single-family starts during April could be a sign that builders are becoming a bit more skeptical of the consumer's ability to continue to support the present level of demand.


GRAPH 9: HOUSING STARTS

Source: Bureau of Census; E NAR estimates.

New Home Sales

Mimicking the three consecutive monthly advances in total housing starts, new single-family home sales rose in April for the third month to an annual rate of 679 thousand units. The April rate was almost 4 percent faster than the March annual rate of 653 thousand units. However, the April annual rate was 6.7 percent below the annual rate of one year ago. The pace of new home sales picked up in each of the four regions monitored: Northeast up 2.8 percent; Midwest up 5.9 percent; South up 2.9 percent; West up 5.5 percent. The annual rate of new home sales is expected to slow somewhat in coming months, reaching an annual total for 1988 of about 642 thousand units, some 4 percent below the 1987 total of 671 thousand units. In 1989, sales of new single-family homes are expected to weaken further to 622 thousand units due to increases in mortgage interest rates.

Existing Home Sales

The pace of existing single-family home sales quickened in April, rising to a seasonally adjusted annual rate of 3.48 million units, 4.5 percent faster than the March annual rate of 3.33 million units. This advance represented the fastest monthly advance in the annual rate since November 1986. Apparently, two factors shared credit for the rapid advance. First, relatively low interest rates in the opening days of the month encouraged homebuyers to make purchases. Later in the month, rising interest rates brought many potential homebuyers off the fence and into the resale market. The fact that springtime homebuying has been very strong in recent years explains why the surprisingly strong April 1988 rate was still below the April 1987 annual rate of 3.59 million units.

On a regional basis, the annual rate of existing single-family home sales advanced in every region but the West, where the rate fell slightly. The regional changes were as follows: Northeast up 6.2 percent to 690,000; the South up 5.7 percent to 1.3 million; the Midwest up 2.3 percent to 900,000; the West down 1.8 percent to 560,000.

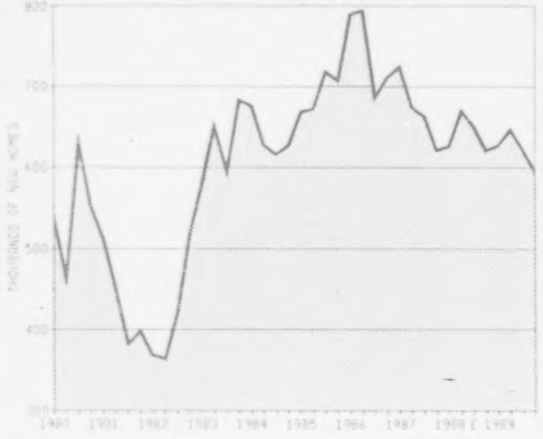
This broad base of existing home sales strength indicates that sales rates are likely to remain strong through the remainder of the springtime buying season. However, the expected upward trend in mortgage interest rates will dampen home sales rates later this summer. Existing single-family home sales are expected to reach 3.34 million units in 1988.

Home Prices

The median existing single-family home price fell $200 from March to April to $87,700, which is 2 percent above the $86,000 year-ago price. The slight decline in prices is part of an overall leveling off in home prices this Spring. New home price appreciation has also slowed in recent months. In the remainder of 1988, both new and existing home prices are expected to increase only modestly, but keeping pace with the rate of overall price inflation

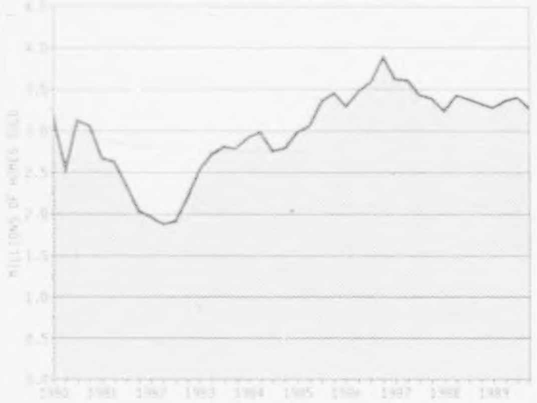
Sean A. Burns
Research Economist
Forecasting & Policy Analysis Division

GRAPH 10: NEW HOME SALES



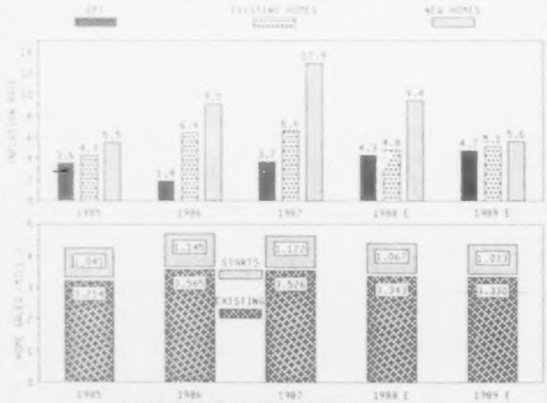
SOURCE: BUREAU OF CENSUS; E = NAR FORECAST.

GRAPH 11: EXISTING SINGLE-FAMILY HOME SALES
(Seasonally Adjusted Annual Rates)



SOURCE: NAR ECONOMICS & RESEARCH, E = NAR FORECASTING & POLICY

GRAPH 12: HOMES ARE APPRECIATING IN REAL TERMS...



...DESPITE WEAKER HOUSING DEMAND

NOTE: New home total equals 97% of single-family starts.

U.S. ECONOMIC OUTLOOK

JUNE 1988

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1986	1987	1988	1989	1990
AGGREGATE ECONOMY												
Gross National Product (billions of dollars)	4607	4669	4742	4815	4886	4962	5046	4235	4486	4776	5080	5398
% Change	7.6	5.4	6.4	6.4	5.9	6.4	7.0	5.6	6.0	6.4	6.3	6.2
% Change (w/out inflation)	4.8	3.9	2.9	3.0	2.4	2.4	3.0	2.9	2.9	3.6	2.6	1.9
Consumer Price Inflation (CPI)	3.6	3.4	4.6	4.5	4.4	4.7	4.8	1.9	3.7	4.1	4.6	5.1
GNP Inflation (GNP Deflator)	2.7	1.7	3.4	3.2	3.2	4.0	3.9	2.6	3.0	2.7	3.7	4.3
Unemployment Rate - Civilian	5.9	5.7	5.4	5.3	5.2	5.2	5.1	7.0	6.2	5.4	5.2	5.5
Civilian Employment-Household Basis (millions)	113.5	114.2	115.1	115.7	116.2	117.1	117.5	109.6	112.4	115.3	117.3	118.5
Percent change	2.3	2.5	3.1	2.1	2.3	2.5	2.0	2.3	2.6	2.4	1.7	1.0
Index of Industrial Production	133.0	139.6	141.3	143.1	143.8	144.2	145.4	125.1	129.8	136.6	139.6	140.9
Manufacturing Capacity Utilization	82.2	82.6	83.1	83.5	83.6	83.6	83.7	79.7	81.0	83.2	83.7	83.1
Domestic Auto Sales	6.7	7.6	7.2	6.9	7.0	7.0	7.0	8.2	7.1	7.2	7.1	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	20.1	20.5	20.2	20.3	20.4	20.4	19.5	20.4	20.4	20.4	21.0
Federal Expenditures (NIPA) as % of GNP	24.0	23.9	23.6	23.7	23.8	23.7	23.6	24.4	23.8	23.7	23.6	23.5
Deficit (NIPA)	-165.9	-175.0	-156.6	-167.0	-171.3	-164.4	-158.5	-204.7	-152.8	-158.9	-163.6	-142.9
as % of GNP	-3.6	-3.8	-3.3	-3.4	-3.5	-3.3	-3.1	-4.8	-3.4	-3.3	-3.2	-2.6
REAL ESTATE MARKETS												
HOME SALES												
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4447	4305	4531	4459	4352	4322	4418	4717	4649	4388	4342	4208
Percent change -- year ago	-12.2	-10.3	-3.5	-1.6	-2.1	.4	-2.4	10.9	-1.4	-5.6	-1.0	-3.1
Existing Single-family Home Sales (1000)	3390	3240	3430	3380	3325	3280	3365	3565	3526	3343	3330	3236
Percent change -- year ago	-12.8	-10.4	-4.9	-1.7	-1.9	1.2	-1.8	10.9	-1.1	-5.1	-0.4	-2.8
Housing Starts (thousands)	1533	1485	1572	1542	1470	1517	1503	1805	1634	1517	1450	1362
Percent change -- year ago	-10.7	-16.5	-2.1	-4.7	-4.1	2.2	-4.4	3.6	-9.8	-7.2	-4.4	-6.1
Single-Family Units	1090	1098	1136	1113	1059	1075	1086	1179	1157	1101	1065	1024
Percent change -- year ago	-6.2	-11.8	-0.1	-3.6	-2.8	-2.1	-4.4	10.0	-1.9	-4.84	-3.27	-3.85
Multi-Family Units	443	387	463	429	411	442	417	631	477	416	385	338
2-4 Family Units	56	58	65	64	61	66	62	84	66	62	57	50
Percent change -- year ago	-35.9	-26.6	-9.7	16.4	8.9	13.8	-4.6	-10.1	-21.2	-6.1	-8.1	-12.3
5+ Family Units	387	329	371	365	350	376	355	542	412	354	328	289
Percent change -- year ago	-17.1	-27.5	-6.3	-10.8	-9.33	14.29	-4.31	-5.9	-25.1	-14.08	-7.34	-11.89
New Single-family Home Sales (thousands)	621	626	670	651	621	627	647	750	671	642	622	534
Percent change -- year ago	-12.6	-11.9	-0.6	-3.4	0.0	0.2	-3.4	9.0	-10.1	-4.3	-3.1	-14.1
Mobile Homes Shipped (thousands)	232	207	212	199	194	193	191	249	233	203	187	174
HOME PRICES												
Existing Home Prices - Median ($1000)	85.0	87.8	88.0	90.6	92.5	93.4	94.0	80.3	85.6	89.7	94.3	99.3
Percent change -- year ago	6.0	3.2	5.4	6.1	9.6	7.6	7.7	6.4	6.6	4.8	5.1	5.3
New Home Prices - Median ($1000)	111.8	114.3	111.5	114.2	115.3	116.0	118.4	92.0	104.0	113.8	120.2	125.0
Percent change -- year ago	19.5	17.4	7.7	7.0	3.7	2.2	4.7	9.1	12.9	9.4	5.6	4.0
FINANCIAL MARKETS												
Long-Term Interest Rates												
30-yr FRM (FHA Secondary)	10.8	10.1	10.5	10.8	11.0	11.2	11.3	9.9	10.2	10.5	11.0	11.5
1-year ARM (without buydown)	8.2	7.5	7.3	7.3	7.5	7.7	8.0	7.9	8.2	7.4	8.0	8.5
Corporate AAA Bond Rate	10.2	9.6	9.9	10.0	10.2	10.3	10.5	9.0	9.4	9.9	10.7	11.0
Government Bond Rate	9.2	8.6	9.2	9.5	9.5	9.7	9.8	7.8	8.6	9.2	9.9	10.2
Short-Term Interest Rates												
Federal Funds Rate	6.9	6.7	7.1	7.2	7.3	7.3	7.5	6.8	6.7	7.0	7.5	7.8
3-month T-Bill Rate	5.9	5.8	6.3	6.4	6.5	6.7	6.8	6.0	5.8	6.2	6.9	7.1
Prime Rate	8.9	8.6	8.9	9.0	9.1	9.3	9.3	9.2	8.6	8.9	9.5	9.8
Discount Rate	6.0	6.0	6.0	6.3	6.5	6.8	7.0	9.2	8.6	6.2	7.0	7.3
Value of the U.S. Dollar (Trade-Weighted Avg.)	92.3	90.0	88.8	88.4	87.7	86.3	85.1	112.3	96.9	87.5	82.7	80.3
Percent change -- year ago	-13.8	-9.9	--8.4	-10.4	-5.0	-4.1	-4.2	-21.6	-13.6	-9.7	-5.5	-3.0

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

Secondary Market Outlook

by
Mary A. Fruscello
Division Vice President
Real Estate Finance

A proposal to deregulate the Ginnie Mae servicing fee could have a profound effect on the cost and availability of FHA and VA financing for homebuyers.

Ginnie Mae, the Government National Mortgage Association, is a federal agency that guarantees timely payment of principal and interest on pools of FHA, VA and FmHA Loans backed by securities issued by approved lenders. These "Ginnie Maes" have become the cornerstone of the mortgage-backed securities market, providing liquidity and safety to the investor, and paving the way for securitization by Fannie Mae, Freddie Mac and private lenders.

The Ginnie Mae program has been one of the most successful government efforts in mortgage finance, as well as one of the most profitable. Over $476 billion of Ginnie Mae securities have been issued since the program began in 1970, and, as of the end of Fiscal Year 1987, Ginnie Mae had paid out only $22.2 million in claims against its guarantee.

A proposal by the Administration to permit flexibility in setting the servicing fee retained by the Ginnie Mae issuer is viewed with concern by mortgage lenders, who fear its adoption could threaten the viability of the Ginnie Mae and even FHA programs.

On its face, the proposal seems attractive. Under the most popular Ginnie Mae program, the mortgage banker/issuer pools loans of identical interest rates, and is required to issue a security with a face interest rate that is 50 basis points (.50%) less that the interest rate on the loans in the pool. For example, 10% FHA loans would be pooled into a 9.50% Ginnie Mae security.

Investors in the security receive their principal payments each month, as borrowers repay their loans, and interest at the face rate of the security. The .50% difference between the rate the borrower pays and the rate the investor receives is divided between the issuer and Ginnie Mae. Ginnie Mae receives 6 basis points as a guarantee fee. The remaining 44 basis points is retained by the issuer as compensation for "servicing" the loan-- collecting payments from borrowers, reporting to Ginnie Mae, remitting proper payment to investors, collecting delinquent payments and where necessary, handling loans to foreclosure.

The amount of the servicing fee is critical, because it is the primary source of profit for lenders who sell their loans in the secondary market.

Under the proposed change, the lender/issuer would be permitted to set its servicing fee below the currently required 44 basis points, down to some minimum required level. This flexibility would allow the issuer to retain a lower servicing fee and assign a higher interest rate to its Ginnie Mae.

The effect of a higher security interest rate is a higher price to the issuer when the Ginnie Mae is sold--a 9.75% security, for example, is worth more than a 9.50% security.

Thus, if the proposed change were adopted, a lender/issuer could increase the proceeds from the sale of a Ginnie Mae merely by reducing its servicing fee and raising the security interest rate. In effect, the lender would have traded future income (the higher servicing fee, which is paid each month on the outstanding principal balance of the loans in the pool) for more cash up front, at the time the security is sold.

This tradeoff, however, could result in a servicing fee inadequate to cover the costs of servicing and produce a profit. The issuer must still service the loans in the pool, which requires that it maintain servicing systems and personnel. Further, the servicer must remit principal and interest payments to investors whether or not the borrower has paid; the servicer is reimbursed either when the borrower catches up on the delinquent payment, or when the loan goes into foreclosure.

Reduced servicing compensation would reduce cash flow to the servicer available to meet remittance requirements, and could result in an unprofitable servicing operation, forcing cutbacks in payment collections and other loan administration activities. Curtailing such efforts often leads to higher delinquencies and foreclosures, which would increase costs to Ginnie Mae and FHA. Ultimately, these higher costs would be passed on to the borrower, who could find government mortgage programs too expensive relative to conventional loan sources.

The experience with Ginnie Mae's FHA multifamily security program is a telling case in point. The allowable servicing spread was low--only 10 basis points--and issuers could earn a much higher price on the security than if they were required to retain a higher servicing fee. The result was high delinquencies, because issuers could not afford to maintain appropriate levels of servicing personnel and facilities.

The designers of the original Ginnie Mae program recognized the dangers of inadequate servicing fees. The program was structured to provide a benefit to the lender/issuer, in the form of the Ginnie Mae guarantee and its attendant benefits of safety and marketability. In return, the lender is required to "earn" this value added over time, as the servicing fee is collected.

By providing the alternative of collecting more value up front, in the form of a higher price for the Ginnie Mae security, the proposal gives lenders a strong financial incentive to "cash out" in the short run, which could set the stage for deterioration in the servicing operation. The result could be significant damage to the Ginnie Mae program and the FHA, VA and FmHA programs it helps to finance.

New Tax Rules and Proposed Tax Laws Affecting Real Estate

Fifteen days before many Americans were rushing to their local Post Office to file their Federal Income Tax returns, the chairmen of two key House and Senate committees were making their own tax filing. These filings, however, were the legislative proposals to fix the tax law's clerical and drafting errors and to provide guidance to taxpayers and tax practitioners in understanding the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1987. Senate Finance Committee Chairman Lloyd Bensten and House Ways and Means Committee Chairman Dan Rostenkowski introduced the Technical Corrections Act (TCA) of 1988 into their respective houses of Congress on March 31, 1988.

THE CURRENT BILLS

The bills (H.R. 4333 and S. 2238) as introduced do not contain many revenue generating or losing provisions. Since these bills appear to be the only vehicles for legislative changes to the tax code this year, many additional proposals for changes to the existing tax code are likely to be considered in both houses. Legislation has already been introduced to extend many provisions of existing law due to expire at the end of 1988. The separate bills could be amended into the TCA.

REAL ESTATE PROVISIONS

Provisions which affect real estate that are currently included in TCA are:

- Replace the term "real estate broker" with "real estate reporting person" in rules requiring that real estate transactions be reported to the Internal Revenue Service.
- Provide that interest on mortgage refinancings undertaken after August 16, 1986 and which do not increase the amount of mortgage debt outstanding remain fully deductible.
- Extend the mortgage credit certificate program through the end of 1988. A drafting error in the Tax Reform Act of 1986 allowed this program to expire at the end of 1987.
- Classify income received from installment sales closed before January 1, 1987 as "passive" income.

POSSIBLE AMENDMENTS

Additionally, several other real estate-related measures may be added to the technical corrections bill. These include:

- Amendments to the passive activity loss rules to allow active real estate owners to deduct out-of-pocket expenses against any type of income not just passive income. A separate bill (H.R. 3224) which would allow for this treatment was introduced by Rep. J.J. Pickle. Rep. William M. Thomas introduced a related measure which would allow taxpayers involved in real estate to deduct losses from properties against income from real estate-related fees and commissions in addition to rental income.
- Revisions in the treatment of unrelated business income. One proposal discussed in the House Ways and Means Committee would consolidate the income of a tax-exempt parent with that of a taxable subsidiary. If most of the income was earned in the taxable subsidiary, then the entire amount of income would be subject to the unrelated business income tax (UBIT). Thus, the taxable income from a Multiple Listing Service would be combined with the non-taxable income of the local board (the tax-exempt parent). If the taxable share of the aggregate income is over 50 percent of the total amount, then all of the income of both the MLS and the local board will be taxed.
- Changes in the capital gains tax rate. For the taxable year 1988 and beyond, all realized capital gains are treated as ordinary income and taxed at ordinary income tax rates. A number of bills to ease the taxes due on capital gains have been introduced. Most of these proposals are viewed as "laying the groundwork" for future changes. Overall, the tax-writers in Congress are reluctant to make any significant changes in the tax code so soon after the passage of the Tax Reform Act of 1986.

THE FUTURE

The Ways and Means Committee is expected to consider TCA in early June with the Senate to begin consideration at a later date. As the members of the tax writing committees seek to include revenue-losing provisions into TCA, they are also seeking means to increase tax revenues to pay for these measures. By balancing revenue losing and revenue raising provisions within TCA, the bill will remain revenue-neutral and thus not change the federal budget deficit. Even with revenue-raising provisions, some Congressmen have projected the price tag of TCA to be in the $14 to $17 billion range. As additional costly measures are added to the bill, its chance of passage diminishes. On the House side, Chairman Rostenkowski has committed himself to passage of TCA this year but, in his words, "it ain't gonna be easy." James Gould, Chief Counsel of the Senate Finance Committee was quoted on the chances of passage during this legislative session as "less than 50-50."

THE CLOCK

The prospects for passage of TCA this year may be influenced by the number of days in which Congress will be in session. As of June 1 there were 64 legislative days left on the House calendar and 65 days left in the Senate. Both bodies of Congress will be out of session in July for the Presidential Conventions plus two weeks in August. Each House has scheduled adjournment for early October which will give all House members plus one third of the Senate time to campaign in their home districts before the November election.

The delays involved in the legislative process result in difficulties for taxpayers and their accountants. To help these individuals make business decisions which could be affected by the changes contained in TCA, some Congressmen have asked the IRS to apply the current rules as if TCA had been enacted. Internal Revenue Service Commissioner Lawrence B. Gibbs and Assistant Treasury Secretary O. Donaldson Chapoton have both stated that they lack the authority to enforce the tax code as if pending legislation were enacted. Therefore, any changes contained in the TCA will not apply to taxpayers unless the legislation is enacted.

PASSIVE ACTIVITY REGULATIONS

On February 19, 1988, the Treasury Department issued the long-awaited first set of temporary and proposed regulations on the passive activity loss limitation. The extensive regulations are as complex as was anticipated. Perhaps the most surprising aspect of the regulations is the extent to which the Treasury aggressively exercised its legislative rule-making authority under the Code to construct barricades on potentially misused declarations of income and expense. The regulations contain many rules which operate in asymmetrical fashion to benefit the treasury but not the taxpayer. Additionally, the regulations provide the definition of "rental activity," and of "material participation" which will be used by the IRS.

The Treasury Department's intent behind many of the rules that specifically affect rental real estate under section 469 of the Internal Revenue Code is to prevent real estate from being used as a "passive income generator" or "PIG." Under the definitions of section 469, the "passive activity loss" for the taxable year cannot be used to offset other types of income. The "passive activity loss" is defined as the excess of losses from passive activities over income from such activities. Under this section, a "passive activity" generally includes any trade or business in which the taxpayer does not materially participate and any rental activity. "Portfolio" income - generally interest and dividend income - is treated as not from a passive activity, and hence cannot be offset by passive losses. Similarly, "earned income" - wages, compensation, and the like - is treated as not from a passive activity. The disallowed passive activity loss may be carried forward indefinitely and deducted in subsequent years to the extent of passive income. Any losses not previously deducted may be deducted without regard to the passive loss limitation when the taxpayer makes a taxable disposition of the passive activity.

The application of phase-in rules permit a decreasing portion of the otherwise disallowed passive loss to be deductible until 1991 on passive activities owned before October 22, 1986. Taxpayers who are subject to the alternative minimum tax are effectively denied the benefit of the phase-in relief. Most significantly, Treasury has the authority to require net income from a passive activity to be treated as not from a passive activity.

Since a "passive activity" includes "any rental activity," the definition of "rental activity" is highly significant. Most real estate rented to commercial or residential tenants will clearly constitute a "rental activity." However, some activities - for example, the operation of a hotel or a residential nursing home - will require a careful analysis of the regulations before a determination can be made as to whether they are rental activities.

WHAT IS A RENTAL?

The code defines "rental activity" as "any activity where payments are principally for the use of tangible property." The regulations adopt this general definition, and also provide that the characterization by the parties of the arrangement as a lease or otherwise is irrelevant. Moreover, a rental activity may exist if the property is being held for rent even if no payment has yet been collected. As a result, any "pre-opening" expenses relating to rental property that somehow escape the grasp of the capitalization rules and the pre-opening expense doctrine will be governed by the passive loss limitation rules.

The regulations prescribe a set of relatively mechanical tests which, if met, will cause an activity in which tangible property is used by customers not to be treated as a rental activity. These tests generally focus on two factors: the average period of customer use and the level of services provided.

1. Customer Use of Seven Days or Less. The regulations provide that an activity involving the use of tangible property is not a rental activity if the average period of customer use is seven days or less. For this purpose, each period during which the customer has a continuous or recurring right to use the property is treated as a single period, regardless of whether the right stems from more than one lease arrangement or from renewal rights.

The legislative history of section 469 indicates that renting hotel rooms generally is not to be treated as a rental activity. The majority of hotels have an average room rental period of seven days or less.

2. Customer Use of Eight to 30 Days. If the average period of customer use is between eight and 30 days and "significant personal services" are provided, the activity will not be a rental activity.

This provision raises two questions. What are personal services, and what determines whether they are "significant?" "Personal services" include only services performed by individuals and do not include services provided in connection with the use of improved real property that are similar to services commonly provided in connections with long-term rentals of high-grade commercial or residential property (e.g., cleaning and maintenance of common areas, routine repairs, trash collection, and security). In addition, "personal services" do not include services performed in connection with improvements or repairs that extend the useful life of the property for a period substantially longer than the average period of customer use. Finally, services necessary to permit the lawful use of the property are not taken into account.

In determining whether the personal services performed are "significant," the regulations state that all facts and circumstances are taken into account. Nevertheless, the critical consideration appears to be the value of the services provided compared to the amount charged to the customer for the use of the property. Examples in the regulations suggest that services with value greater than 50 percent of the amount charged to customers would be significant while services of less than 10 percent value would not be significant. This definition leaves a large gray area in this issue.

3. Customer Use Greater Than 30 Days. If the average period of customer use of the property exceeds 30 days, the activity will nevertheless not be a rental activity if "extraordinary personal services" are provided by or on behalf of the owner in connection with the use of the property. In order to be "personal," the services must be performed by individuals; in order to be "extraordinary," use of the property must be incidental to receipt of the services.

The regulations state that the extraordinary personal services standard "generally" is met with the respect to the use by patients of a hospital's boarding facilities and the use by students of a boarding school's boarding facilities. Whether nursing home and residential care facilities "generally" meet the test is not addressed. An example concludes that extraordinary personal services are not provided where the value of the services (measured by the cost of performing them) exceeds 50 percent of the amount charged for the use of the property.

SPECIAL CASES OF NONRENTAL RENTALS

The regulations provide three special cases in which the rental of property will not be treated as a "rental activity."

1. Property Held for Investment. Rental of property during a taxable year is treated as incidental to holding the property for investment (and therefore not a rental activity) if the principal purpose for holding the property during the year is to realize gain from appreciation and the gross rental income is less than two percent of the lesser of the adjusted basis or the fair market value of the property. The determination of whether the taxpayer's principal purpose is to realize gain from appreciation is made without regard to whether it is expected that such gain will be realized from the sale or exchange of the property in its current state of development. The most common situation that may be expected to come within this exception is the holding for investment of raw land that is subject to a grazing or hunting lease.

2. Property Used in a Trade or Business. Rental of property during a taxable year is treated as incidental to use of the property in a trade or business (and therefore, not a rental activity) if the property is "predominantly used" in the trade or business during the taxable year or during at least two of the five immediately preceding taxable years and the gross rental income from the property is less than two percent of the lesser of the unadjusted basis or the fair market value of such property. The regulations give no guidance as to what constitutes "predominant use"; presumably, use in the trade or business for more than half of the total time used will qualify.

3. Property Held for Sale to Customers. If property is sold during the taxable year and at the time of sale the property is held primarily for sale to customers in the ordinary course of a trade or business any rental of the property during the year of sale is treated as incidental to the activity of dealing in the property (and therefore, not as a rental activity). As discussed below, the interaction of this rule with the rules relating to characterization of gain on the disposition of property may have consequences that are unexpected by the taxpayer and unintended by the government.

THE TAX TREATMENT OF GAIN FROM THE DISPOSITION OF REAL ESTATE

1. The General Rule. The regulations provide that gain recognized upon the sale of property used in a passive activity in the year of sale is generally treated as passive income, regardless of whether the gain is recognized in the year of sale or subsequently under installment method. Thus a disposition of real estate that is used in a rental activity in the year of sale will generally give rise to passive income. Any material portion of a property (e.g. a building) that is used in a different activity from the balance of the property at any time prior to the sale is treated as a separate property, and the amount realized on the sale and the basis of the property sold must be allocated among the deemed separate properties in a reasonable manner. For example, assume a taxpayer sells a ten story building part of which was used in an active trade and the remainder of which was leased to others at all times prior to sale. The building is treated as two separate properties, therefor the amount of capital gains realized and the adjusted basis must be allocated accordingly.

2. Pre-1987 Installment Sales. The Internal Revenue Service took the position that the gain recognized in 1987 and later years from pre-1987 installment sales was never passive income, even though the property sold was clearly used in a passive activity. This position seems to be in conflict with the general rule that the nature of the activity in the year of disposition determines whether the gain from disposition of an asset is passive income or otherwise. Additional regulations limit the extent to which active income can be transformed into passive income through the planning and timing of different activities.

The Technical Corrections Act now before Congress would classify this income as passive. If the property was used in more than one type of activity (both active and passive), then any gain realized through disposition must be allocated between the activities on any basis that reasonably reflects the use of the property during the preceding twelve months. Another rule applies if the assets is "predominately used" in a particular activity and its fair market value does not exceed the lesser of $10,000 or ten percent of the value of all the properties used in that activity.

3. Substantially Appreciated Property. If the fair market value of property sold exceeds 120 percent of its adjusted basis at the time of sale, any gain on the sale that would otherwise be treated as passive will be treated as

nonpassive. This provision holds unless the property was used in a passive activity for either 20 percent of the period held by the taxpayer or the entire 24-month period ending on the date of sale.

THE RULES IN CONCERT

The interaction of the general rule regarding characterization of gain on sale and the rule regarding rental incidental to holding property for sale as a dealer may work at cross purposes with unfortunate (and possibly unintended) results. For example, assume that a taxpayer who owns an apartment building wishes to convert the building to condominium units and sell off the units. In previous years, the taxpayer might have sold the building to a condominium converter in order to avoid dealer status and realize any gain on sale as capital gain rather than ordinary income. With the elimination of the preferential treatment of capital gains, under current law the taxpayer may be more inclined to convert the building himself. If he does so, he almost certainly will be a dealer, and the rule for rental incidental to holding property primarily for sale to customers in the ordinary course of business will apply.

Under the incidental rental rule, the activity will not be a rental activity in the year the units are sold, and the allocation rule for property used in multiple activities during the 12 months preceding sale will therefore apply. If the taxpayer materially participates in the dealing activity, the portion of the gain on sale of the units that the allocation rule treats as allocable to the dealing activity will be active; the balance of the gain will be allocable to the rental activity and will be passive. Similarly, if the taxpayer does not materially participate but does "significantly participate" in the dealing activity, the portion of the gain that the allocation rule treats as allocable to the dealing activity will be subject to recharacterization as nonpassive. Because the allocation rule looks to the use of the property in the 12 months preceding sale, and because the incidental rental rule treats the activity as nonrental from the beginning of the taxable year than if they are sold near the end of the year. Accordingly, the well-advised owner/converter will conduct the sales effort in the fall but postpone closing on sales of units until the following January, thereby minimizing the amount of gain that may be characterized as active.

Moreover, in determining whether an individual materially or significantly participates in an activity, the regulations generally look to the total number of hours of participation in the activity during the taxable year, and do not prorate for participation in activities for less than a full tax year. Thus, if closing on sales of the units occurs early enough in January, it will be impossible for the taxpayer to meet the hourly thresholds for material or significant participation, and even the small amount of gain allocable to the dealing activity will be passive.

THE DEFINITION OF ACTIVITY

Many important issues await clarification in future regulations due to be issued before June 1, 1988, including the definition of "activity." This definition is crucial for at least four separate purposes under the regulation. First, the determination of whether a taxpayer materially participates in an activity can only be made if it is known what "the activity" is. Second, any previously suspended passive losses are deductible when the taxpayer disposes of his entire interest in "the activity." Third, the scope of the activity must be known in order to determine whether the gross income from the conduct of "the activity" is principally for the use of tangible property, and thus whether the activity is a "rental activity." Fourth, the definition of activity is central in determining whether the taxpayer owns an interest in a "pre-enactment activity" eligible for phase-in relief. Treasury Department officials have informally indicated that they are considering a broad definition for purposes of the material participation test, but are concerned that a broad definition may be too harsh for purposes of the disposition rules. It is possible that the regulations will adopt different definitions of "activity" for different purposes.

OTHER ISSUES

Beyond the issuance of the rules defining "activity" and clarifying other issues, the regulatory agenda is unclear. Many other significant areas remain to be addressed, including the treatment of dispositions under section 469, the rules for "active participation" real estate eligible for the $25,000 offset, the treatment of trusts and estates and publicly traded partnerships subject to these rules. Moreover, the preamble to the regulations already issued indicates that the IRS intends to monitor closely taxpayer efforts to structure passive income generators, and will prescribe additional anti-PIG rules as needed. Plainly, there is plenty to keep government lawyers and tax practitioners alike busy for years to come. Advocates on both sides of these issues will be occupied with understanding the new regulations and corrections to the tax laws for many years.

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REAL ESTATE OUTLOOK

Vol. 1, No. 7

July 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Real GNP growth in the first quarter was revised downward to 3.6 percent from 3.9 percent. The June downward revision was primarily due to a slowdown in the estimated rate of advance of consumer spending in the first quarter.
- The trade deficit fell in April to the slimmest margin in more than three years. The $9.9 billion figure indicates that the trade deficit is finally getting some relief from the weaker dollar as imports actually decreased by 6 percent in April.
- Increased demand for U.S. goods, both at home and abroad, has been pushing U.S. manufactures to near capacity levels. Although re-tooling efforts are underway in many industries, only time will tell if capacity can be expanded far enough and soon enough to minimize shortages and price increases.
- A severe drought has raised expectations that food prices will be higher later in the year, triggering price increases on a variety of food items. The drought has also increased expectations for higher rates of inflation which has in turn put upward pressure on mortgage interest rates.
- May sales of existing homes rose for the fourth consecutive month to a seasonally adjusted rate of 3.63 million units, with advances in every region across the nation. This steady rise seems to be fueled not only by the traditional springtime homebuying season, but also the belief that interest rates could be heading higher.

IN THIS ISSUE

- **Economic Commentary: SAY GOODNIGHT, GRACIE, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Building a National Housing Policy for the 1990s and Beyond, by Fred Flick**
- **Technical Corrections to Tax Law Under Consideration, by Kevin Yeats**

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SAY GOODNIGHT, GRACIE

Economic Commentary

by

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The crash was supposed to plunge the economy into recession; it didn't. The falling dollar was supposed to unleash runaway inflation reminiscent of the 70s; it didn't. Our declining productivity and profligacy as a nation was supposed to subjugate our economy to the rest of the world; it hasn't. What's going on here?! While economists have occasionally been more spectacularly wrong, never have they (whaddya ya mean *they*, Kimo Sabe?) been so consistently wrong in so many small ways.

It's not time to give up on the usefulness of economic analysis as a tool for arranging public life, but it is time to consider how the changes that have occurred and are occurring in the American economy have escaped the consideration of the profession's main stream. In brief, economists have been wrong so much recently because they rely on models for most of their analysis, because these models have been inadequate to deal with change of the dimensions we have seen, and because, when the models have not worked, the economists have tried to wing it. And those of you who have heard the myriad of economist jokes know, improvisation is not a natural state for most of the dismal scientists.

Each of these aspects requires some elaboration, so, as the local sportscaster is wont to say, let's go to the video tape.

Economists believe in models. This is probably the backbone of practicing economics. Abstractions have been a common source of commentary since Aesop. But often abstractions can fail to capture the real guts of the issue and then may lead to useless advice, e.g., how can one look before leaping if they who hesitate are lost? In some sense, this is happening now. Models which rely on wealth to predict economic activity (a fairly common variety) would have concluded that the stock market crash would have unleashed a recession of proportions unprecedented since 1929, and indeed this is what we read about for a good two months after the crash. In fact, the distribution of wealth is such that this was not the case. What is missing most often from models is common sense. It is, for example, far more useful to forecasting to consider whether one's driving is impeded by public works projects (a sure sign of prosperity, since state and local governments are most active when the economy is best), rather than looking at the quadratic reaction function (I'm not kidding here) of monocentric economic agents. When the latter is more important than the former, economists will be wrong.

Models can be wrong. As the economy changes fundamentally, models must similarly change. Keynesian economics, born of the failures of other models during the Great Depression, is a prime example here. We simply need to see things with a different eye. Right now, there are some real changes going on in the American economy that may require some revisions in the way we look at what goes on. A good case in point is the unemployment rate. In the Seventies, an unemployment rate of 5.5 percent would have been the signal for severe pressure on prices, because at that rate, the economy would be overheated. So, when the unemployment rate reached that level earlier this year, the models said that inflation was going up quickly. In fact, the population structure of this country has shifted during the Eighties to the degree that we can easily sustain an unemployment rate of 5.5 percent *or lower* without seeing inflation rise like Godzilla from some volcano. In the economics profession, there is some real questioning of conventional wisdom. While that questioning proceeds, forecasting is going to be far less accurate.

Economists wing it. John Kenneth Galbraith once said that economists forecast not because they're good at it, but because people ask them to. And lately, more and more people are asking. As financial news becomes more interesting and important to the general public and as the outlets for this news increase, more and more economists are being asked to comment on every little statistic. With the models we use, every little statistic is not forecast. Combine this with the fact that the models have been shaky lately, and you've got the case where economists have to think on their feet about what's going on. Often it doesn't work. Their answers are dull, incomprehensible, wrong, or all of the above. In fact, the more esteemed the credentials of the economist, the more learned and academic the background, the more "scientific" the models are, the worse are the answers.

Having trashed my own profession, I think it only fair to soften up a bit. What I am really suggesting is that most of economics, at least from the perspective of the general public, is common sense. Too much, the profession relies on spatial location models to determine the best markets, rather than asking regional franchise managers where they will be placing their franchises and why. To be useful (if that is the goal), economists need to develop a common sense touch that will translate their own knowledge and insight into terms that will make it available to their consumers. And when changes are occurring and the models are giving out less reliable information, that common sense is simultaneously more useful and more elusive.

In a sense, the scientific economists are the Harry Von Zells and Blanche Mortons of the world dealing with Gracie Allen. In her own cockeyed way, Gracie saw more of reality more accurately than they could with their more conventional frames of reference. Although Gracie's strings of logic were as convoluted as DNA, they were always grounded in some observation of the real rather than some assumption. I think, in essense, she is a useful guide to the times. Of course, the real economist of the bunch was George Burns, who translated those strings of logic for the rest of us! Goodnight, Gracie.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

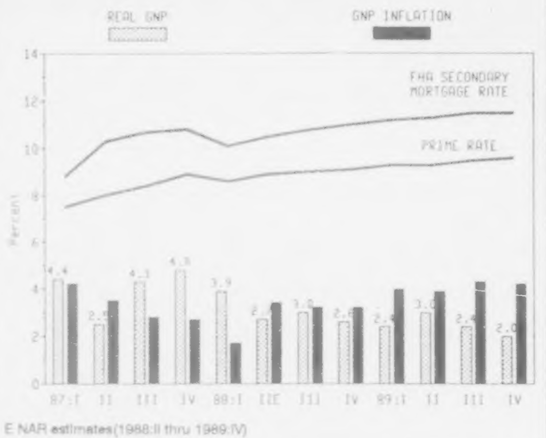
The Gross National Product (GNP) advanced at an inflation-adjusted annual rate of 3.6 percent in the first quarter, according to revised estimates from the Department of Commerce. Last month, first quarter growth had been revised upward to a 3.9 percent annual rate from the April estimate of 2.3 percent. The June downward revision (from 3.9 to 3.6 percent) was mainly due to a $3 billion reduction in the rate of advance of consumer spending. Personal consumption expenditures grew at an annual rate of 3.8 percent, instead of the previous estimate of 4.3 percent. In contrast, the revision for corporate profits from current production in the first quarter was $1.0 billion higher than previously estimated. However, even with the upward revision, corporate profits shrank $2.1 billion in the first quarter. Domestic profits of nonfinancial corporations can be credited with most of the revision's increase, climbing $9.1 billion in the first quarter, up from its $3.1 billion preliminary estimate, and well above its fourth quarter decrease of $6.9 billion.

Finally, the J-Curve

The April trade deficit fell to a surprisingly narrow $9.9 billion, the slimmest margin in more than three years. And if one month's data does not a trend make, consider this: the merchandise trade gap for the first three months of 1988 was $47 billion (seasonally adjusted annual rate), a fat 15 percent below the same statistic for 1987. Since the dollar's fall began in February 1985, expectations of a sharply improving trade deficit have been frustrated by a number of factors, including profit cutting by foreign producers to maintain market share, and of course the economics principle that trade imbalances lag currency changes. But really, it all boils down to simple arithmetic; call it the "Law of Large Numbers". The dollar value of U.S. imports has been running nearly twice that of U.S. exports, meaning that even a small, steady rise in imports can offset a faster rise in exports. The result is a widening nominal trade deficit, despite strong export growth. Now it seems the recent surge in exports may have begun to overwhelm the import rise. And the April numbers on imports gave a welcome boost: U.S. imports actually declined by 6 percent from the March total. This forecast does not anticipate that imports will steadily decline in the coming months, but the recent data does suggest a slower rise in value. The benefit is two-fold: exports get a leg up on the "Law of Large Numbers", and April's data on imports could mean that U.S. consumers are beginning to shift their preferences away from imports and back to American made goods.

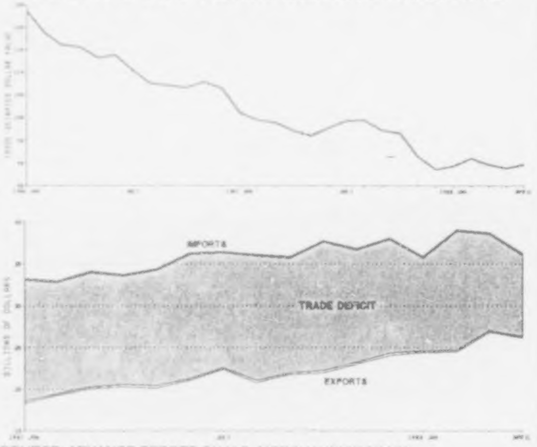
Graph 3 shows the trend in trade that is hidden behind the monthly trade deficit numbers. The graph shows how the *volume* of exports has risen relative to that of imports when compared on a percent change from prior year basis. By this measure, the first quarter data shows the volume of U.S. exports has risen almost one-third above its 1987 first quarter level. In contrast, the volume of U.S. imports has advanced less than 10 percent over the same period. With a growth differential of this magnitude, then the U.S. trade picture could become increasingly bright: even to the point of expecting a trade surplus by 1990.

GRAPH 1: THE ECONOMIC OUTLOOK



E NAR estimates(1988:II thru 1989:IV)

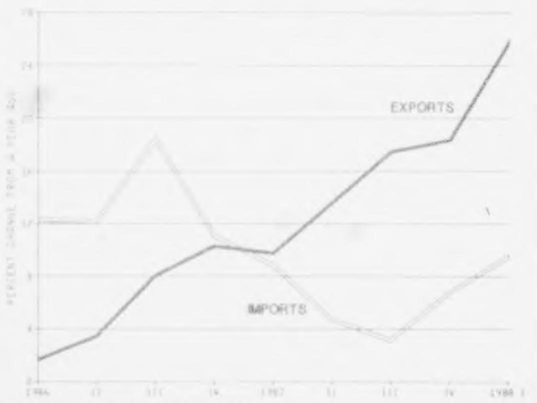
GRAPH 2: THE TRADE DEFICIT NARROWS



SOURCE: ADVANCE REPORT ON U.S. MERCHANDISE TRADE

GRAPH 3: A TRADE SURPLUS BY 1990?

(PERCENT CHANGE IN THE VOLUME OF TRADE)



SOURCE: BUREAU OF ECONOMIC ANALYSIS.

The Heat Is On At U.S. Manufacturers...

Greater demand for U.S. exports means that U.S. businesses must now serve two masters. First, they are faced with satisfying the demands of foreign consumers for less expensive American goods. At the same time, U.S. businesses are also trying to woo the American consumer away from higher-priced imports. This is complicated in industries like the auto industry where U.S. manufacturers have followed foreign price increases with price hikes of their own. On the whole, however, U.S. manufacturers are operating their plants at near capacity levels in response to the increased export demand. Re-tooling efforts are underway in many industries, but only time will tell if enough new capacity can be brought on line to minimize shortages. Already shortages of needed component parts are raising the possibility of more price hikes at the intermediate level. In short, the explosive growth in export demand is a positive development only to the extent that U.S. manufacturers can react to the increased production requirements without resorting to rationing products through much higher prices.

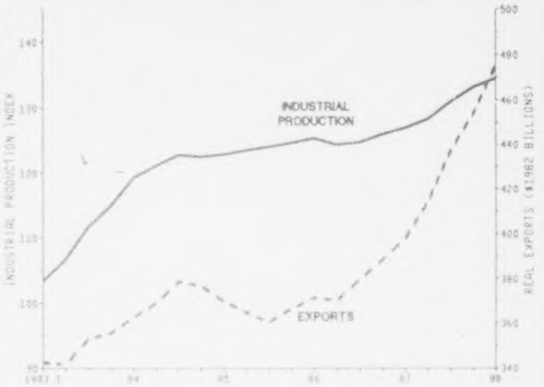
And They Plan To Do Something About It

Evidence of the re-tooling effort underway at the nation's factories has shown up in recent government surveys. The U.S. Bureau of Economic Analysis surveyed businesses in the first quarter of 1988 regarding their plans to spend for new plant and equipment this year. According to the first quarter survey, U.S. businesses *plan* to spend $423 billion for new plant and equipment this year, $4 billion more than they estimated when last surveyed (during the fourth quarter of 1987). If realized,this $423 billion would represent a 9 percent gain over their 1987 *actual* expenditures. For comparison, the 1987 total marked only a 2.4 percent rise over their 1986 *actual* expenditures. However, as businesses fail to realize their planned expenditures, the tendency is to not adjust the annual estimate until yearend. Nevertheless, the survey underscores the fact that U.S. manufacturers realize the need to expand plant and equipment in order to meet the enormous demand for exports.

Inflation Outlook May Depend on Food Prices

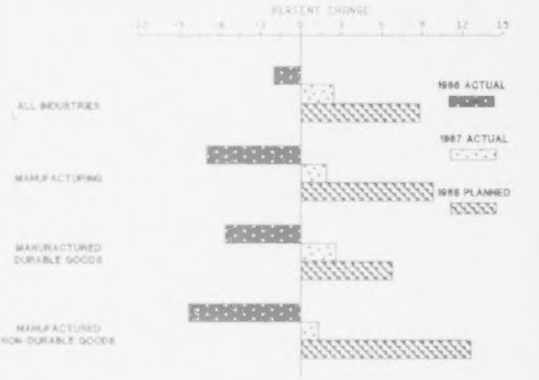
How successful U.S. businesses are at expanding capacity to handle the increased demand for exports is one of the key determinants in the outlook for inflation. If capacity constraints continue, the inflation rate may rise on account of shortages and higher wage demands. A new variable in the inflation outlook is the path food prices will take in the coming months. A severe drought gripping the Farm Belt has raised fears that crop yields will be sharply reduced and meat supplies similarly affected. The expectation that food prices will be higher later this year has already triggered price increases on a variety of food items. But these early price effects should not be taken as the leading edge of a broad and rapid rise in food prices. The reason is twofold: first, a shortage of grains will likely be absorbed somewhat by stockpiles; second, the full effects of higher prices on primary goods like grains take time to work through the production process. The current forecast raises the inflation rate slightly in the second half of 1988 to account for the rise in food prices.

GRAPH 4: INDUSTRIAL PRODUCTION KEEPS PACE WITH RISING EXPORT



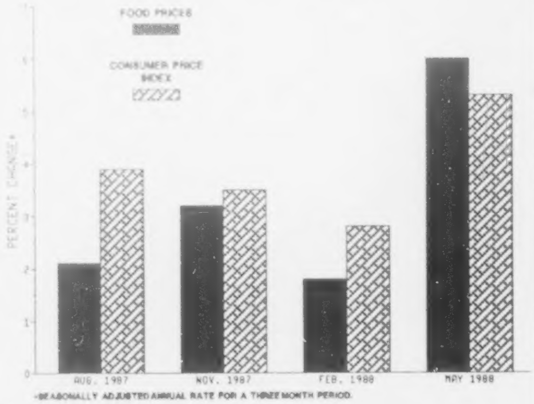
SOURCE: BUREAU OF ECONOMIC ANALYSIS.

GRAPH 5: INCREASED DEMAND FOR US GOODS PUSHES INVESTMENT PLANS HIGHER



SOURCE: SURVEY OF CURRENT BUSINESS, DEPT. OF COMMERCE

GRAPH 6: FOOD PRICES ARE ON THE RISE



SOURCE: BUREAU OF LABOR STATISTICS.

The real cost of the drought, however, may be a longer-term weakening of the U.S. farm trade position. U.S. farm exports are not only important to the agricultural sector, they have also been a key surplus component in the U.S. trade balance. As the graph shows, U.S. farm trade suffered from the high value of the U.S. dollar in the early 1980's, making a modest rebound in 1986 that accelerated through 1987 and still looks good so far in 1988. In fact, foreign buyers of U.S. farm exports are now rushing to place orders before prices accelerate. And even if prices do rise, these higher prices could potentially offset the anticipated decline in volume. But despite this possibility and the presence of stockpiles, a severe drought will almost certainly derail plans for the U.S. to regain its dominant role in world agricultural trade. Already, some large deals with foreign importers have had to be scuttled because the U.S. government would have had to make large subsidy payments.

Inflation Pushes Up Long-term Rates

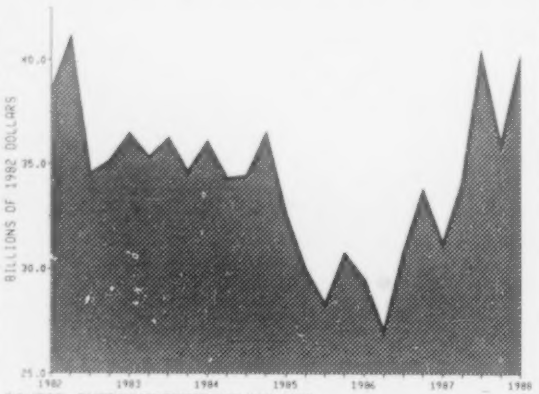
While the drought leads to poor expectations about the prospects for growth in U.S. agricultural trade it is also adding to expectations of faster rates of price increases. In turn, these expectation are keeping upward pressure on mortgage interest rates. Through much of 1987, the principal cause of faster inflation was expected to come from rising prices on U.S. imports, while domestically driven price increases were not thought likely because the U.S. economy was growing at a sluggish rate. Because of the explosive export growth, U.S. economic growth in 1988 has been considerably faster than expected, setting the scene for domestically driven inflation. Capacity constraints being reached at many U.S. manufacturers, expectations for higher wage settlements, and now higher food prices, are all contributing to the general belief that inflation is heating up. Although the measures of inflation are staying within a moderate band of 4-5 percent, it is inflation *expectations* that feed into mortage interest rates. Therefore, this forecast projects the secondary market yield on FHA mortgages will surpass 11 percent by the end of 1988, and average 11.3 percent in 1989.

REAL ESTATE MARKETS

Housing Starts

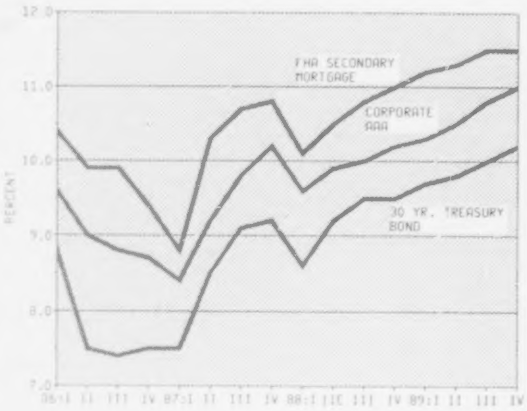
The seasonally adjusted annual rate of housing starts was 1.384 million units in May, a 12 percent decline from the April annual rate of 1.576 millions units. The May annual rate was 13.5 percent below the May 1987 annual rate of 1.599 million units. Single-family housing starts fell to 988,000 units, 9.2 percent below the April annual rate of 1.088 million units. Multi-fimily housing starts declined by 18.9 percent to an annual rate of 396,000 units in May. Of these, starts of structures with five of more units fell to an annual rate of 333 thousand units, 22.6 percent below the April annual rate of 430 thousand units. Starts of structures with two to four units bucked this trend, rising to an annual rate of 63,000 units in May, 8.6 percent faster than the April rate of 58,000 units. The current forecast projects that rising mortgage interest rates will continue to dampen housing starts activity in 1988(1.495 million units) and into 1989(1.450 million units).

GRAPH 7: AGRICULTURAL EXPORTS HAVE BEEN EXPANDING



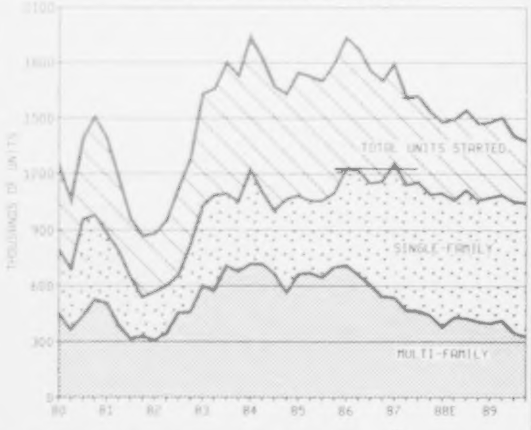
SOURCE: BUREAU OF ECONOMIC ANALYSIS

GRAPH 8: LONG-TERM INTEREST RATES



SOURCE: THE FEDERAL RESERVE BOARD

GRAPH 9: HOUSING STARTS



SOURCE: BUREAU OF CENSUS: E NAR ESTIMATES

New Home Sales

From February to April the rate of new single-family home sales consistently advanced. This trend finally came to an end in May with new single-family home sales dropping slightly to an annual rate of 658 thousand units, down 0.3 percent from the April rate of 660 thousand units. However, May also witnessed the end to another trend and, for the first time in nine months, the new single-family home sales rate rose *above* the rate of the previous year, increasing 1.4 percent from the May 1987 annual rate of 649 thousand units. The only region to suffer any real losses was the Northeast, where the sales rate fell 7.3 percent to an annual rate of 101 thousands units. This decline more than offset the 6.4 percent sales gains experienced in the Mid-west. In both the South and West sales remained relatively unchanged, at 271 thousand units and 185 thousand units respectively.

Existing Home Sales

Sales of existing single-family homes rose in May to a seasonally adjusted annual rate of 3.63 million units, a 3.1 percent gain over the April annual sales rate of 3.2 million units. After falling almost 5 percent in January, the annual rate of single-family home sales has risen steadily in each succeeding month. Further, May marked the second straight month in which existing homes were sold at the fastest pace of the preceding twelve months.

The May existing home sales rates advanced in every region across the nation. The Northeast region recorded the largest advance, moving up 10.4 percent in May to a seasonally adjusted annual rate of 740,000 units, 1.4 percent faster than the May 1987 annual rate. Sales in the Midwest advanced by 3.2 percent in May to an annual rate of 960,000 units, but were 1.8 percent slower than the May 1987 annual rate. The forces behind this steady rise in home sales seem to extend beyond the traditional springtime homebuying season. One of these forces is the belief that long-term interest rates could be headed higher, despite the upcoming presidential election. However, the rate rise is not expected to strangle home sales. Rather, a gradual rise in long-term rates will probably cause a moderate slowdown in home sales rates to about the 3.4 million unit level during the remainder of 1988. Existing single-family home sales are expected to total 3.37 million units in 1988.

Home Prices

The Median price of an existing single-family home rose to $88,600 in May, a 1.5 percent gain over the April median price of $87,300. Every region of the country shared in the price advance: the median price in the Northeast rose 11.0 percent to $148,700; the West up 10.2 percent to $122,000; the Midwest up 2.7 percent to $68,300; and the South up 1.6 percent to $83,100. The national median price of an existing single family home is expected to reach $89,700 in 1988, a 4.8 percent rise over the 1987 median price of $85,600.

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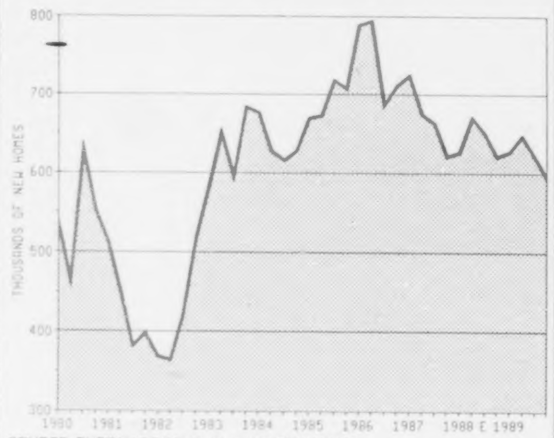
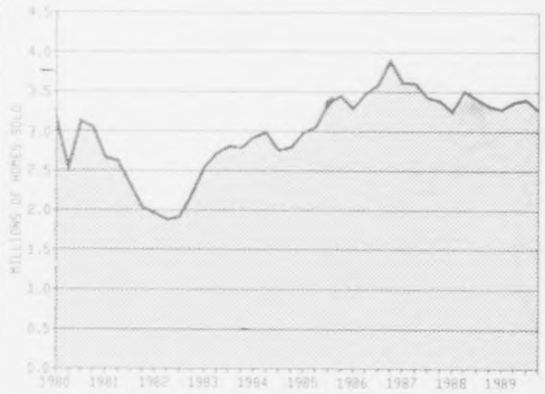
GRAPH 10: NEW HOME SALES



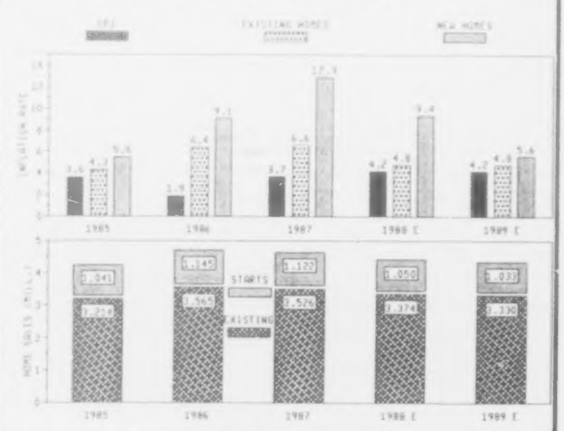
SOURCE: BUREAU OF CENSUS; E NAR ESTIMATES

GRAPH 11: EXISTING SINGLE-FAMILY HOME SALES
(SEASONALLY ADJUSTED ANNUAL RATES)



SOURCE: NAR ECONOMICS AND RESEARCH; E NAR FORECASTING & POLICY

GRAPH 12: HOME PRICES



NOTE: New home total equals 97% of single-family starts.

BUILDING A NATIONAL HOUSING POLICY FOR THE 1990s AND BEYOND

by
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Division Vice President
Forecasting and Policy Analysis

Introduction

Over the past decade, some disturbing trends in the state of the nation's housing have developed:

- The after-tax cash cost of homeownership, which peaked in the early 1980s, is still very high.
- The homeownership rate has declined steadily since 1980, especially among households in the 25-34 age range.
- Inflation-adjusted gross rents are at their highest level in two decades.
- The supply of low-cost rental housing is shrinking due to abandonment or upgrading for higher-income occupants.
- The increased rental payments burden, especially among single-parent families, has contributed to the rise in homelessness.

These trends have been affecting the ability of low- and moderate-income families to find acceptable rental housing and moderate- to middle-income families to make the transition from rental housing to homeownership. The ability for moderate income families to become homeowners over the past four decades has been called "The American Dream." Researchers and policymakers across the country are asking whether our society will continue to help families achieve this dream and, over the past year, have been providing input into the legislative process to help develop a new national housing policy. This article documents the empirical evidence relating to the decline in homeownership, increased costs of owner-occupied and rental housing, and impacts on various demographic segments of the housing market.

The Homeownership Rate

The homeownership rate, measured in the Census Bureau's *Current Population Survey*, is the percentage of housing units that are owner-occupied. Since the mid-1960s, it steadily rose from 63 percent to a high of 65.6 percent in 1980. However, since then, it has dropped to 64 percent. Although, this decline seems small in percentage terms (2.6 points), with almost 90 million families occupying individual housing units, it suggests a loss of roughly 1.44 million owners. Certainly, if the rate of homeownership had continued to increase through 1987, we could expect upwards of 2 million more homeowners than we have now.

The decline in the homeownership rate is a nationwide phenomenon affecting areas with strong and weak economies alike. However, there is a regional side to the problem, as well:

- The homeownership rate has fallen off most sharply in the Midwest, though marked declines occurred in the South and the West as well.
- The growth in the number of elderly homeowners in the Northeast helped offset the effect of declining homeownership rates of young households. In the Northeast, many older households have owned their homes for years and have therefore been insulated from the housing cost inflation of the late 1970s and early 1980s.

But, the most critical aspect of the problem is the concentration of the decline among younger households:

- For households aged 25 to 29, the homeownership rate fell from 43.3 percent in 1980 to 35.9 percent in 1987.
- Households aged 30 to 39 suffered similarly sharp declines.
- Even those in the 45 to 54 age group had a 5.5 percent decline.
- Only those in the 55+ age grouping experienced increases in their ownership rate.

Reasons for the Decline in Homeownership

High Cash-Cost of Owning

A recent study by the Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing 1988*, documents the increasing after-tax cash cost of homeownership and the increasing gross burden of rents as the major factors. The high costs of renting are preventing potential homebuyers from accumulating the resources needed to make downpayments and meet initial year carrying costs to own a home.

The Harvard study shows that the after-tax cash cost (mortgage payment plus property tax, insurance, fuel and utilities, and maintenance costs less tax savings of homeownership) for potential first-time homebuyers (defined by median income married couple renters aged 25 to 29) rose from a low of 22 percent in 1967 to the mid- to high 30 percents in the late 1970s; was 45 percent during the housing recession; and was 32 percent in 1987. The total burden (including the after-tax cash cost plus the opportunity cost of the downpayment, amortization

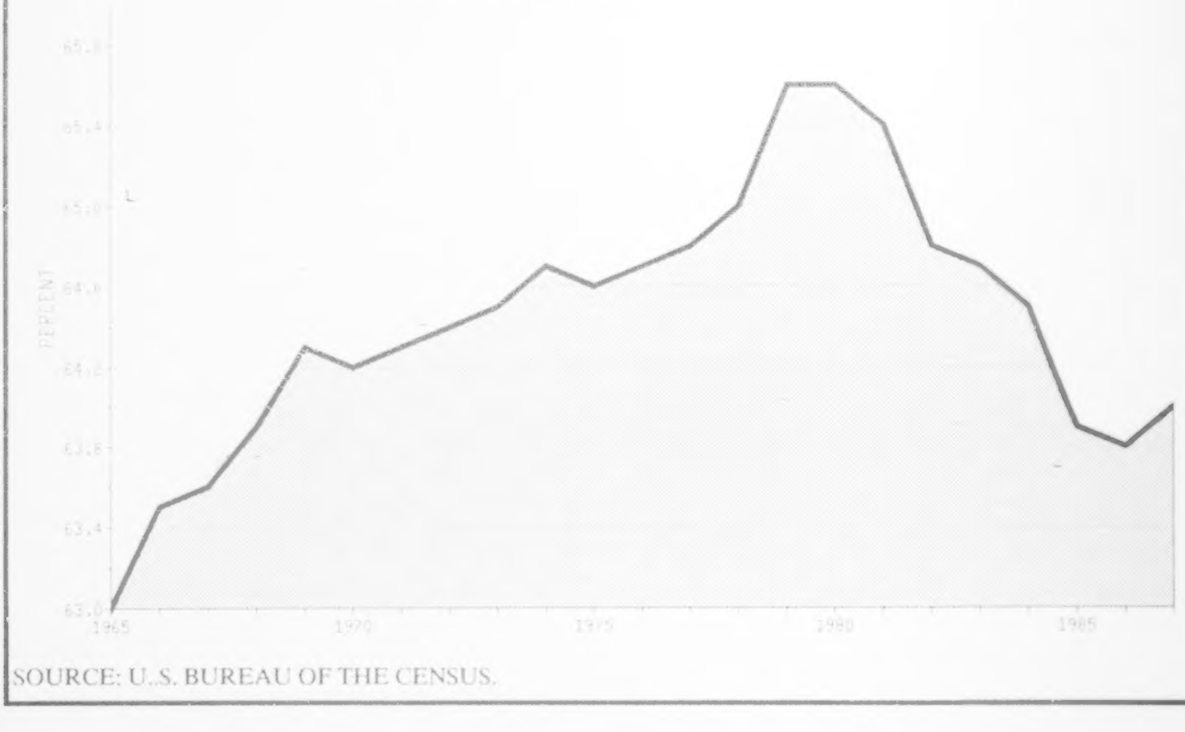
HOMEOWNERSHIP RATES

(PERCENT HOMEOWNER)

	1973	1976	1980	1983	1987
Region					
Northeast	59.2%	59.8%	60.7%	61.4%	61.4%
Midwest	69.1	69.5	70.3	70.0	67.1
South	66.5	66.4	68.3	67.1	66.9
West	60.6	61.2	60.5	58.7	57.9
Age					
Under 25	23.4%	21.0%	21.3%	19.3%	16.1%
25-29	43.6	43.2	43.3	38.2	35.9
30-34	60.2	62.4	61.1	55.7	53.2
35-39	68.5	69.0	70.8	65.8	63.8
40-44	72.9	73.9	74.2	74.2	70.6
45-54	76.1	73.9	74.2	74.2	70.6
55-64	75.7	72.7	75.2	76.9	78.1
65-74	71.3	72.7	75.2	76.9	78.1
75 +	67.1	67.2	67.8	71.6	70.7
TOTAL	64.4	64.8	65.6	64.9	64.0

SOURCE: 1973 to 1980 from Annual Housing Survey, 1983 to 1987 from Current Population Survey.

HOMEOWNERSHIP RATE, 1965 TO 1987



SOURCE: U.S. BUREAU OF THE CENSUS.

and closing costs, less expected equity buildup) is lower, due primarily to expected the equity buildup from homeownership. However, in order to secure equity, a potential homebuyer must qualify to carry the cash cost burden. Thus, the downpayment is the major factor which determines the mortgage amount and therefore the monthly principal and interest payment. Saving for the downpayment has been a major problem for many renters who are potential homebuyers.

Increased Rental Burden

The Harvard study also documents the substantial increases in the gross rent (contract rent plus fuel and utilities, property taxes and insurance) burden for various categories of households by age and family type.

- In the mid-1970s only single parents with children had rent burdens over one-third of their income. Single householders and married couples all had rent burdens ranging from 14 to 19 percent of income.
- However, by the 1980s, things had changed significantly. The gross rent burden for single parents aged 25 to 34 had increased to 58 percent of their income. For married couples with children, rents moved from 17 to almost 22 percent of income; and, even married couples without children had to pay almost 18 percent of their income for rent.
- In 1987, even single elderly, at a 42 percent gross rent burden, are better-off in rental housing than are single parents with children.
- For the 35 to 44 age group, 1987 rental gross burdens are the lowest across all groups, even single parents with children pay under one-third of their income for rent.
- Households under 25 carry some of the highest gross rent burdens of all groups; however, their situation in the mid-1970s was bad as well.

Conclusions

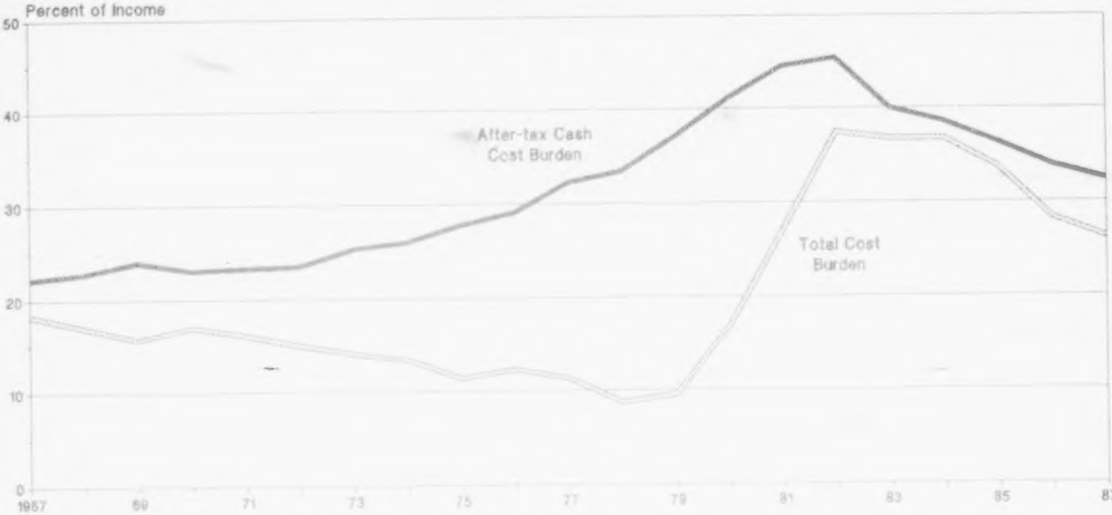
Since the mid-1970s there has been a substantial worsening in the housing situation of low- to moderate-income renters and potential first-time homebuyers. Although young married-couple renters earn more than other renters, their incomes have not kept pace with homeownership costs.

The relatively low incomes of renter households have important implications for housing in America. Low incomes limit the ability of many households to secure adequate and affordable housing in the non-subsidized private marketplace. They also shrink the pool of potential first-time homebuyers. With the incomes of young renter households failing to keep pace with inflation, the construction and sales of housing targeted to first-time buyers will suffer.

These conclusions suggest the need for a new look at national housing policy and for the development of innovative solutions to these problems.

FIRST-TIME HOMEBUYER COST BURDEN

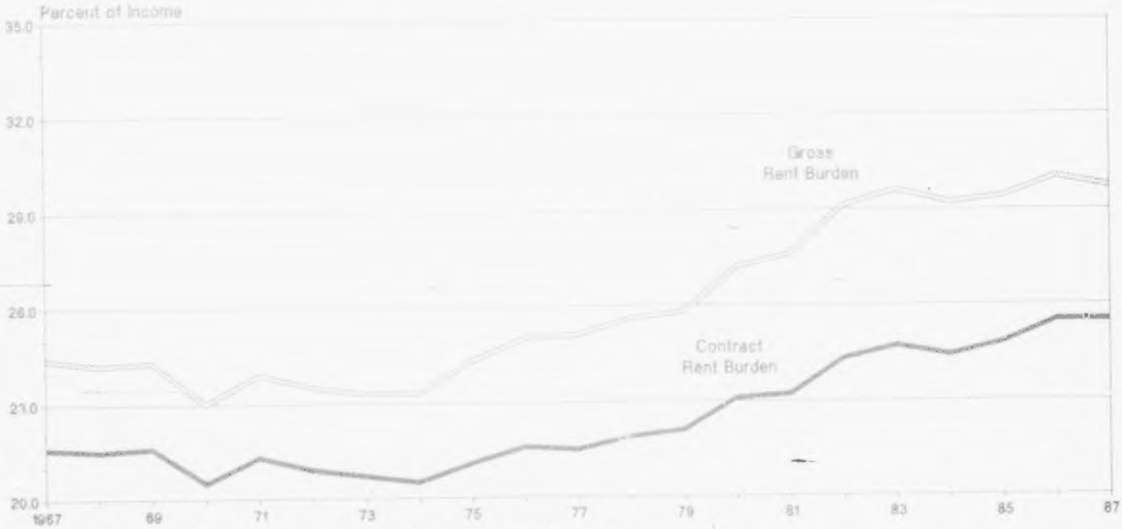
(COST AS A PERCENT OF INCOME)



Source: The State of the Nation's Housing 1988, Joint Center for Housing Studies of Harvard University, P.9 and Appendix Table 1.

RENTAL COST BURDEN

(COST AS A PERCENT OF INCOME)



Source: The State of the Nation's Housing 1988, Joint Center for Housing Studies of Harvard University, P.9 and Appendix Table 1.

RENT BURDEN BY AGE AND FAMILY TYPE

	MEDIAN INCOME (1986 DOLLARS)		GROSS RENT (1986 DOLLARS)		GROSS RENT BURDEN	
Age and Family Type	1974	1987	1974	1987	1974	1987
Household Head Under 25						
Single	$11,732	$12,437	$287	$318	29.3%	30.7%
Married With Children	18,608	13,690	292	324	18,9%	28.4%
Married No Children	22,325	17,879	329	365	17.7%	24.5%
Single Parent With Children	7,248	4,581	279	309	46.2.%	81.1%
Other Households	11,906	11,279	367	407	37.0%	43.3%
TOTAL	15,828	11,737	312	348	23.7%	35.6%
Households Head 25 to 34						
Single	20,623	17,817	331	367	19.2%	24.7%
Married With Children	24,160	20,899	344	382	17.1%	21.9%
Married No Children	32,059	29,028	382	424	14.3%	17.5%
Single Parent With Children	10,965	7,271	319	354	34.9%	58.4%
Other Households	20,908	19,098	395	438	22.7%	27.5%
TOTAL	22,340	18,199	347	385	18.7%	25.4%
Households Head 35 to 44						
Single	19,282	19,934	325	360	20.2%	21.7%
Married With Children	26,715	23,793	363	403	16.3%	20.3%
Married No Children	30,200	29,749	359	398	14.3%	16.1%
Single Parent with Children	12,665	12,988	325	360	30.2%	32.7%
Other Households	16,999	19,288	325	360	22.9%	22.4%
TOTAL	21,963	20,357	343	375	18.8%	22.1%
Household Head 45 to 64						
Single	11,615	10,341	257	285	26.6%	33.1%
Married with Children	24,406	21,662	348	386	17.1%	21.4%
Married No Children	26,170	25,092	350	388	16.0%	18.5%
Single Parent With Children	12,013	9,961	310	343	30.9%	41.4%
Other Households	15,565	14,333	294	326	22.7%	27.3%
TOTAL	18,216	15,732	306	333	20.1%	25.4%
Household Head 65 or Older						
Single	6,300	6,409	203	225	38.6%	42.1%
Married	12,379	13,766	302	335	29.4%	29.0%
Other Households	11,160	10,457	257	285	27.5%	32.8%
TOTAL	8,836	8,540	238	257	32.4%	36.0%

Source: The State of the Nation's Housing 1988, Joint Center for Housing Studies of Harvard University, Appendix Table 11.

Technical Corrections to Tax Law Under Consideration

The principal tax-writing committee in the House of Representatives began consideration of the Technical Corrections Act (TCA) of 1988 on June 21. The House Ways and Means Committee under Chairman Dan Rostenkowski began making amendments to the bill which was introduced on March 31, 1988.

While the ostensible purpose of TCA is to correct drafting errors and clarify troublesome language in existing laws, the bill is likely to be the only vehicle for changes in tax laws that will be considered this year. Thus, committee members are amending the bill to include other substantive changes to the tax code and extension of the tax provision which are set to expire in the near future. Some of these amendments lose tax revenue and thus may need to be paired with revenue-generating amendments in order to limit the bill's impact on the federal budget.

Chairman Rostenkowski has circulated among the committee members a list of possible revenue-raising options. The committee, in its early deliberations, has identified five major revenue raisers. These five proposals are:

- Repeal of completed contract method of accounting. This provision affects mainly defense contractors.
- Accelerate corporate estimated tax payments.
- Repeal Alaska Native Corporations special rules for loss transfers. An accounting change which affects consolidated statements of loss for certain corporations.
- Reduce portfolio dividends received deduction in steps to 50 percent. This rule applies to corporations which own less than 20 percent of the stock of another corporation.
- Tighten restrictions on single-premium and investment-oriented life insurance and annuity products. This provision is aimed at curbing the use of these financial products as tax shelters. (See *Tax Notes* June 20, 1988, p. 1358-1359 and June 27, 1988, p. 1494-1497).

The bill alters the Mortgage Revenue Bond program to target the benefits to low-income households. These revisions are discussed in the next section. The Low-Income Housing Credit and the Unrelated Business Income Tax are also reviewed below.

MORTGAGE REVENUE BOND AND MORTGAGE CREDIT CERTIFICATE PROGRAMS

The TCA would extend the authorization of the states to issue qualified mortgage bonds and to trade-in bond authority in exchange for authority to issue mortgage credit certificates. Both programs would be extended through December 31, 1990.

Modifications

Several modifications would be made to the rules governing these programs to target their benefits to low-income households.

- The purchase price limit for assisted homes would be reduced to 75 percent of the average area purchase price (95 percent in targeted economically distressed areas).
- Income limits would be adjusted for family size as is done currently for multifamily rental housing bonds and for the low-income rental housing tax credit.
- Income limits would be determined by reference to area median incomes, and special adjustments would be provided (subject to a maximum limit of 140 percent and a minimum limit of 90 percent) for nontargeted areas having significantly higher or lower than national ratios of area median income to area purchase prices (so-called "high cost" or "low cost" areas).
- Issuers of qualified mortgage bonds and qualified veterans' mortgage bonds would be required to rebate arbitrage profits to the Federal Government under the rules that now apply to issuers of governmental and other private activity bonds.
- A three-year loan origination period would be imposed for qualified mortgage bonds. Undisbursed proceeds and prepayments (received during the three-year period) would be required to be used to redeem bonds no later than six months after expiration of the origination period. Prepayments received thereafter would be required to be used to redeem bonds no later than the close of the six month period following their receipt.
- An amount equal to the special subsidy provided by qualified mortgage bond-financing or an MCC (but not in excess of 50 percent of gain) would be recaptured on disposition of the house. Full recapture of this special subsidy would occur if the house were sold within 5 years; recapture would phaseout in years 6 through 10. A special rule would exclude from recapture part or all of the special subsidy in the case of assisted individuals whose incomes were less than prescribed amounts at the time of the disposition. The recapture provision would not apply in the case of home improvement loans. However, different versions of this recapture rule have been circulated among committee members. The exact formula may change before enactment.

THE LOW-INCOME RENTAL HOUSING TAX CREDIT

The tax credit may be claimed by owners of newly constructed, rehabilitated, and newly acquired existing residential rental property used for low-income housing. The credit is claimed annually, generally for a period of ten years. Credit percentages are adjusted monthly for buildings placed in service in that month to maintain a present value of the credit stream of 70 percent of qualified expenditures for most newly constructed and rehabilitated housing. A 30-percent present value is allowed in the case of acquisition of existing housing and of newly constructed or rehabilitated housing receiving other Federal subsidies, including tax-exempt bond financing.

To qualify for the credit, a low-income rental housing project must continuously comply with the requirements of the credit for a period of fifteen years after it is placed in service. The principal requirement is that a minimum percentage of housing units be continuously set-aside for use by individuals having incomes below prescribed levels. The minimum percentage is 40 percent for tenants having incomes of 60 percent or less of area median, or 20 percent for tenants having incomes of 50 percent or less of area median. A lapse in compliance with this or other Code requirements generally will result in the denial of the credit prospectively as well as a recapture of a portion of the tax benefits previously allowed, including an interest component to account for the time value of money.

The annual credit authority limitation for each state is equal to $1.25 for each individual who is a resident of the state. Ten percent of each state's credit authority is set aside for exclusive use for projects in which qualified non-profit organizations participate. Credit authority is scheduled to lapse after December 31, 1989.

The TCA would extend present law through December 31, 1990. A conforming amendment would defer for one year the present-law provision permitting a limited carryover of the credit cap from the last year of the program into the following year.

The period since its inception shows a pattern of increased utilization of the low-income rental housing credit. An extension of the tax credit at this time will help to ensure continuity in the usage of this housing program, and will afford the committee an opportunity to gather more information on its operation and relative efficiency before deciding to continue, modify, or eliminate the program.

OTHER TAX MATTERS: UBIT

While the Technical Corrections bill was in the Congressional limelight, the House Ways and Means Oversight Subcommittee was considering a revision of the Unrelated Business Income Tax (UBIT). The UBIT is levied on the income from a subsidiary of a tax-exempt organization such as the gift shop income of a charitable hospital. The subcommittee is considering language to clarify which activities qualify as unrelated and how to calculate aggregate net income of the parent and subsidiary.

The subcommittee proposed to redefine the term "controlled organization" to refer to parent tax-exempt organizations that own more than a 50 percent interest in any subsidiary whether the measure is value or voting power. The subcommittee maintained that the taxable income of a controlled subsidiary should not be less than the UBIT amount would be if the subsidiary's income-producing activity had been carried on by the exempt parent.

The subcommittee proposed new rules to determine whether the primary purpose of an organization is tax-exempt when that organization owns subsidiaries that are not exempt. These recommendations focus on the activities and income of subsidiaries in which the parent has at least an 80 percent ownership interest.

The subcommittee proposed that in calculating the so-called aggregation rule, the IRS should: (1) compare the amount of attention given by exempt organization directors and staff to unrelated business activities and the organization's expenditures for exempt activities versus costs for taxable activities; (2) note the income derived from different activities; and (3) determine whether there is a reasonable expectation of earning a profit. (See *Tax Notes*, June 27, 1988, p. 1498-1499).

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U.S. ECONOMIC OUTLOOK

JULY 1988

	QUARTERS							YEARS				
	Actual		Forecast					Actual		Forecast		
	1987.4	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1986	1987	1988	1989	1990
AGGREGATE ECONOMY												
Gross National Product (billions of dollars)	4607	4669	4742	4815	4886	4962	5046	4235	4486	4776	5080	5398
% Change	7.6	5.4	6.4	6.4	5.9	6.4	7.0	5.6	6.0	6.4	6.3	6.2
% Change (w/out inflation)	4.8	3.9	2.9	3.0	2.4	2.4	3.0	2.9	2.9	3.6	2.6	1.9
Consumer Price Inflation (CPI)	3.6	3.6	4.5	4.7	4.4	4.7	4.8	1.9	3.7	4.2	4.2	5.1
GNP Inflation (GNP Deflator)	2.7	1.7	3.4	3.2	3.2	4.0	3.9	2.6	3.0	2.7	3.7	4.3
Unemployment Rate - Civilian	5.9	5.7	5.4	5.3	5.2	5.2	5.1	7.0	6.2	5.4	5.2	5.5
Civilian Employment-Household Basis (millions)	113.5	114.2	115.1	115.7	116.2	117.1	117.5	109.6	112.4	115.3	117.3	118.5
Percent change	2.3	2.5	3.1	2.1	2.3	2.5	2.0	2.3	2.6	2.4	1.7	1.0
Index of Industrial Production	133.0	139.6	141.3	143.1	143.8	144.2	145.4	125.1	129.8	136.6	139.6	140.9
Manufacturing Capacity Utilization	82.2	82.6	83.1	83.5	83.6	83.6	83.7	79.7	81.0	83.2	83.7	83.1
Domestic Auto Sales	6.7	7.6	7.2	6.9	7.0	7.0	7.0	8.2	7.1	7.2	7.1	6.9
Federal Tax Receipts (NIPA) as % of GNP	20.4	20.1	20.5	20.2	20.3	20.4	20.4	19.5	20.4	20.4	20.4	21.0
Federal Expenditures (NIPA) as % of GNP	24.0	23.9	23.6	23.7	23.8	23.7	23.6	24.4	23.8	23.7	23.6	23.5
Deficit (NIPA)	-165.9	-175.0	-156.6	-167.0	-171.3	-164.4	-158.5	-204.7	-152.8	-158.9	-163.6	-142.9
as % of GNP	-3.6	-3.8	-3.3	-3.4	-3.5	-3.3	-3.1	-4.8	-3.4	-3.3	-3.2	-2.6
REAL ESTATE MARKETS												
HOME SALES												
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4447	4314	4536	4489	4352	4322	4418	4717	4649	4424	4342	4208
Percent change -- year ago	-12.2	-10.1	-3.4	-0.9	-2.1	0.2	-264	10.9	-1.4	-4.8	-1.9	-3.1
Existing Single-family Home Sales (1000)	3390	3250	3509	3410	3325	3280	3365	3565	3526	3374	3330	3236
Percent change -- year ago	-12.8	-10.3	-2.7	-0.9	-1.9	0.9	-4.1	10.9	-1.1	-4.3	-1.3	-2.8
Housing Starts (thousands)	1533	1477	1492	1542	1470	1477	1503	1805	1634	1495	1450	1363
Percent change -- year ago	-10.7	-16.9	-7.1	-4.7	-4.1	0.0	0.7	3.6	-9.8	-8.5	-3.0	-6.1
Single-Family Units	1090	1097	1059	1113	1059	1075	1086	1179	1157	1082	1065	1024
Percent change -- year ago	-6.2	-11.8	-6.9	-3.6	-2.8	-2.0	2.5	10.0	-1.9	-6.5	-1.6	-3.85
Multi-Family Units	443	380	433	429	411	402	417	631	477	413	385	338
2-4 Family Units	56	56	62	64	61	59	62	84	66	62	57	50
Percent change -- year ago	-35.9	-26.3	-13.9	16.4	8.9	5.3	0.0	-10.1	-21.2	-7.6	-6.6	-12.3
5 + Family Units	387	324	371	365	350	343	355	542	412	353	328	289
Percent change -- year ago	-17.1	-28.6	-6.3	-10.8	-9.3	5.9	-4.3	-5.9	-25.1	-14.3	-7.1	-11.9
New Single-family Home Sales (thousands)	621	626	670	651	621	627	647	750	671	642	622	534
Percent change -- year ago	-12.6	-11.9	-0.6	-3.4	0.0	0.2	-3.4	9.0	-10.1	-4.3	-3.1	-14.1
Mobile Homes Shipped (thousands)	232	207	212	199	194	193	191	249	233	203	187	174
HOME PRICES												
Existing Home Prices - Median ($1000)	85.0	87.3	88.3	91.0	91.6	92.1	94.1	80.3	85.6	89.7	94.0	98.9
Percent change -- year ago	6.0	3.2	5.7	6.7	7.8	4.9	6.6	6.4	6.6	4.8	4.8	5.2
New Home Prices - Median ($1000)	111.8	114.3	111.5	114.2	115.3	116.0	118.4	92.0	104.0	113.8	120.2	125.0
Percent change -- year ago	19.5	17.4	7.7	7.0	3.7	2.2	4.7	9.1	12.9	9.4	5.6	4.0
FINANCIAL MARKETS												
Long-Term Interest Rates												
30-yr FRM (FHA Secondary)	10.8	10.1	10.5	10.8	11.0	11.2	11.3	9.9	10.2	10.5	11.3	11.5
1-year ARM (without buydown)	8.2	7.5	7.3	7.3	7.5	7.7	8.0	7.9	8.2	7.4	8.0	8.5
Corporate AAA Bond Rate	10.2	9.6	9.9	10.0	10.2	10.3	10.5	9.0	9.4	9.9	10.7	11.0
Government Bond Rate	9.2	8.6	9.2	9.5	9.5	9.7	9.8	7.8	8.6	9.2	9.9	10.2
Short-Term Interest Rates												
Federal Funds Rate	6.9	6.7	7.1	7.2	7.3	7.3	7.5	6.8	6.7	7.0	7.5	7.8
3-month T-Bill Rate	5.9	5.8	6.3	6.4	6.5	6.7	6.8	6.0	5.8	6.2	6.9	7.1
Prime Rate	8.9	8.6	8.9	9.0	9.1	9.3	9.3	9.2	8.6	8.9	9.5	9.8
Discount Rate	6.0	6.0	6.0	6.3	6.5	6.8	7.0	9.2	8.6	6.2	7.0	7.3
Value of the U.S. Dollar (Trade-Weighted Avg.)	92.3	90.0	88.8	88.4	87.7	86.3	85.1	112.3	96.9	87.5	82.7	80.3
Percent change -- year ago	-13.8	-9.9	-8.4	-10.4	-5.0	-4.1	-4.2	-21.6	-13.6	-9.7	-5.5	-3.0

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick and Sean Burns.

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REAL ESTATE OUTLOOK

Vol. 1, No. 8

August 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The economic expansion continued through the second quarter of 1988, as the annual growth rate of real GNP reached 3.1 percent, according to the U.S. Department of Commerce. The second quarter pace was just below the revised first quarter annual rate of 3.4 percent.
- The American economy is enduring a fundamental change in the source of GNP growth, which is coming to rely less on growth in consumer spending and more on growth in export demand and business spending on fixed investment.
- Inflation indicators are throwing out some conflicting signals, but the prospects are good for moderate price advances through 1988. The annual rate of consumer price inflation is expected to remain near 5.0 percent through 1989.
- In an effort to keep inflation under control, the Federal Reserve Board has recently adopted a tighter monetary policy stance by nudging up short-term interest rates. This upward trend in short-term rates has already led to slowly rising long-term interest rates. Rates on 30-year fixed rate mortgages will likely inch above 11 percent by yearend before stabilizing near 11.5 percent in 1989.
- High rates of employment and slowly rising mortgage rates have contributed to the fifth consecutive monthly advance in the annual rate of existing home sales. In June, sales of existing single-family homes reached an annual rate of 3.78 million units, a gain of 5.3 percent over the May annual rate of 3.59 million units and 5.6 percent faster than the sales pace of June 1987.

IN THIS ISSUE

- **Economic Commentary: Dewks, Denks, and the Magnificent Millenium, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns**
- **Obstacles to Becoming a First-Time Homebuyer: A Look at NAR Survey Data, by Daniel N. Chambers and Mary B. Schwartz**
- **Significant Real Estate-Related Technical Corrections, by Kevin J. Yeats**

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DEWKS, DENKS, and the Magnificent Millenium

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

Callin' out around the world
Are you ready for a brand new beat?
--Martha Reeves

In *The Proud Tower,* Barbara Tuchman describes that last glorious summer of western civilization, the period just before World War I. Not since has such an all-pervading sense of optimism been present. On the contrary, in comparison with what has followed, the horrors of the Great War -- which forever shattered that spirit -- seem almost quaint. Depression, war, conflict and tensions have enshrined pessimism as the dominant world view. But now, in the last summer of the age of Reagan, there are some straws in the wind that suggest yet another turn, and a return of hope for a brighter world in the coming millenium.

The political straws are obvious, summarized by perestroika in the Soviet Union and the realization by Iran that dying for Allah works as a foreign policy only until you exhaust the supply of those willing to do so. But let's look at the domestic economy, where there is accumulating evidence that we are poised for expansion through the remainder of the century. Despite the drought, the falling dollar and capacity strains in some industries, inflation has remained modest, and is likely to continue so. The pressures in the labor market that we feared seem not to have materialized. In an earlier day, increased demand for output would have invariably led to union pressures and higher wages. Now, that increase results in slower delivery of output and more modest (if any) wage increases. Translation: the auto workers are still getting the same wage, but on a Saturday noon, it'll take you three minutes longer to get your burger because the fast-food proprietor can't get enough staff despite paying an extra $.15 an hour.

And, while labor pressures -- especially among low-skill jobs -- may well increase, the economy has undergone a transformation that may well keep those pressures from short-circuiting economic growth. The Census Bureau reports that since 1976, married households with both spouses employed and with children (termed by the *Wall Street Journal*, "DEWKs" -- double employment with kids) have increased by 61 percent, and those without children ("DENKs" -- double employment, no kids) are up 31 percent. Moreover, two-thirds of all college-educated married women with children under the age of one are employed outside the home. Now, it has been argued that these figures point up the need for two incomes just to survive. I think, rather, that they suggest the real dimensions of the social revolution that has occurred over the past twenty years. Gainful employment is a proud profession, and labor force participation is up. This will yield a high productivity labor force that will bias the economy toward growth through the remainder of the century.

Bolstering the changes that have taken place in the labor force, is the seeming accommodation this economy has made to the internationalization of goods and securities markets. While the dollar has dropped since 1985, recent movements have been of a fine-tuning nature, and the trade deficit has responded by settling into a "soft landing" glide toward zero. This is stabilizing and reviving those manufacturing industries that have never really recovered from the double blows of high inflation and a surging dollar in the early Eighties. Moreover, the free flow of capital across borders seems to have locked domestic interest rates into a moderate band. Again, stability that should promote growth.

These are only straws in the wind, and much can happen to reverse the current pattern. We still spend more than we earn, and the next president *must* come to grips with Federal deficits quickly. Done wrong, that can scuttle prosperity by as early as the end of next year. But for now, everything is moving in the right direction. Interest rates and inflation remain moderate, unemployment is down and growth continues strongly. More importantly, all this is no fluke -- the fundamental forces that will shape this economy through the remainder of the century are all pointing to continued expansion. If we can smoothly correct the problems posed by the Federal deficit and a low savings rate, then we will end this millenium on a high note. As the song says,

Summer's here and the time is right
For dancin' in the street.

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

Real GNP growth advanced at an annual rate of 3.1 percent in the second quarter, only marginally slower than the first quarter's revised rate of 3.4 percent, according to the latest estimates by the U.S. Department of Commerce. The new data shows that economic growth is becoming more evenly balanced across several sectors of the economy, rather than relying solely on consumer spending. But, in the unending search to make bad news out of good, some analysts suggested the GNP report could touch off an acceleration of the inflation rate. For evidence, they cited the 4.1 percent rate of advance in the GNP deflator (considered to be a broader measure of inflation than the oft-cited CPI) which was much stronger than the 1.7 percent annual rate reported for the first quarter, and the fastest advance since the first quarter of 1984. However, government economists stated that drought-related food price increases were largely responsible for the faster second quarter inflation rate, and that an accelerating rate of price increases was not imminent.

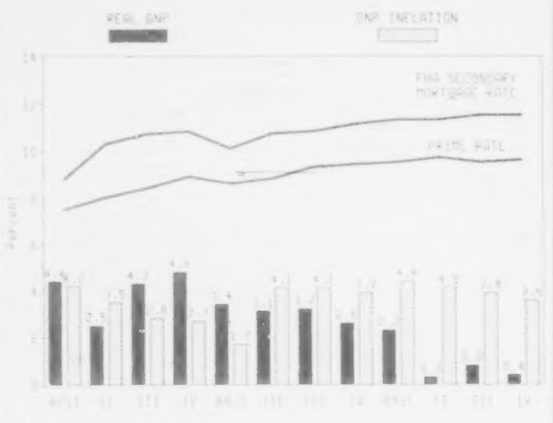
From Consumption to Exports and Investment

The composition of real GNP growth outlined in the second quarter report likely enhances the chances of continued moderate rates of inflation. The reason: a shift in domestic spending away from consumption and into business investment. As seen in Graph 2, the rate of growth in consumer spending slowed to about half the pace of the first quarter. The rate of business spending for equipment was down slightly from the first quarter rate, but was again a large contributor to GNP growth. The purpose for the intensive investments in equipment spending is to allow U.S. firms to meet the demand for U.S. exports. Growth in net exports (exports minus imports) was the largest single contributor to real GNP growth in the second quarter. All of these statistics add up to one central theme: the U.S. economy is managing to make the delicate transition from a consumer-led expansion to one powered by demand for U.S. exports. Such a fundamental change in the source of economic growth has been sought after for some time, and now appears to have arrived.

Profile of a Sea Change

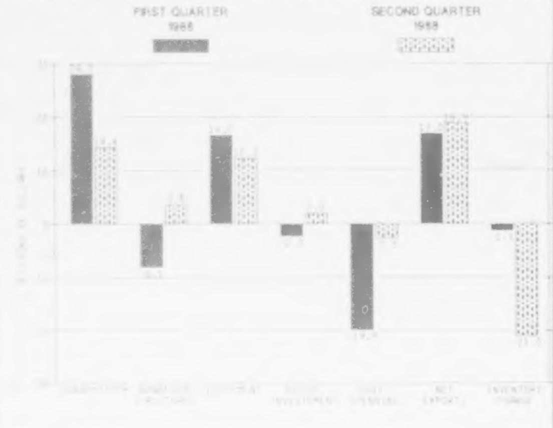
This broad change in the composition of U.S. economic growth (or "sea change" as some call it) has been gaining momentum behind the scenes ever since the dollar began to decline in value during February of 1985. But for reasons ranging from time lags between exchange rate changes and trade flows (often called the J-curve), to substantial profit margins on imports that kept U.S. dollar prices from rising, the improvement in trade has been a long time in coming. As recently as the first quarter of 1987, spending on fixed investments by U.S. businesses had been dropping. Meanwhile, export growth began rising steadily in the third quarter of 1986, and then explosively from the second quarter of 1987. While capacity constraints are being reached in many industries, U.S. firms have embarked on a major re-tooling effort to meet the increased export demand. Fortunately, domestic consumption has remained modest.

GRAPH 1: THE ECONOMIC OUTLOOK



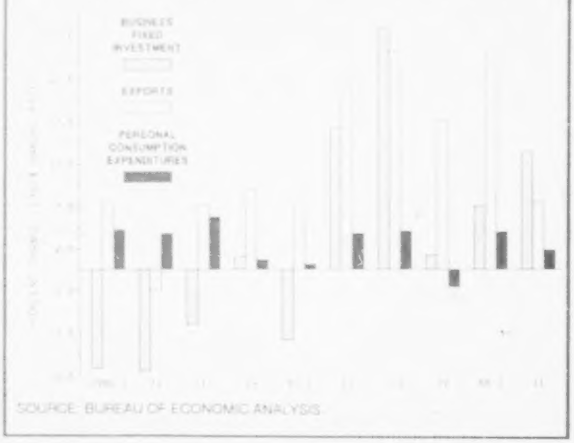
E NAR estimates(1988:II thru 1989:IV)

GRAPH 2: THE COMPOSITION OF GNP GROWTH



SOURCE: Dept. of Commerce, Bureau of Economic Analysis.

GRAPH 3: CONSUMPTION REMAINS MODEST AS EXPORT AND INVESTMENT GROWTH SURGES



SOURCE: BUREAU OF ECONOMIC ANALYSIS

Where Have All the Consumers Gone?

As the previous graph shows, growth in consumption has been lagging the rate of advance of exports and business fixed investment. But actually, in the course of the present sea change in economic growth, fast growth rates in consumption are not desirable. A resurgence of consumer spending at a time when business investment and export growth are surging could overheat the economy and produce a recession. What is the likelihood of another growth surge in consumer spending? Probably pretty slim, what with consumer installment debt as a percent of personal income nearing 16 percent. In fact, for the past few years it has been fashionable to say that the consumer has spent himself into an oblivion of installment debt. The only way out is for the consumer to buy down this debt, rather than rack up new purchases. Recent data on personal saving suggest the consumer may have begun to do so. If so, a prolonged period of modest growth in consumption and an increasing savings rate could contribute to economic growth that is more balanced across all sectors.

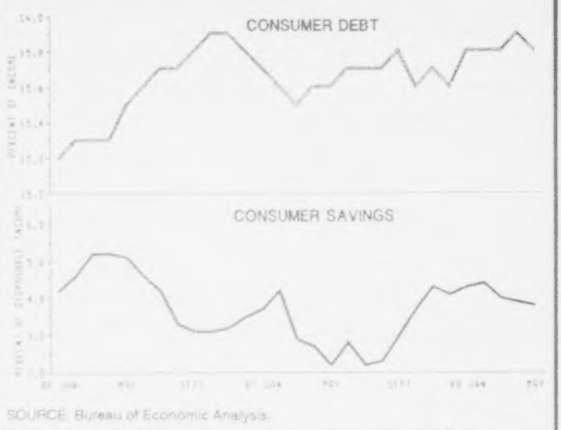
Inflation Stays Moderate

The second quarter GNP report was in almost every respect a perfect report -- demand was not overheating, and it was distributed across several sectors. The report's one imperfection was that the GNP deflator indicated a faster rate of overall inflation than had been expected. The deflator rose from an annual rate of 1.7 percent in the first quarter to 4.1 percent in the second quarter. As said earlier, the drought was partly to blame for the deflator's advance. But other potential sources of inflation remain. Prices of imported goods, for example, have continued to rise as the lower dollar has forced many foreign producers to raise the dollar prices of their goods exported to the U.S. Wages in the manufacturing sector, still being held under control, could be the next source of inflation if domestic production to meet export demand is not accommodated by sufficient gains in capacity. The more commonly quoted measure of inflation, the consumer price index (CPI), shows the rate of inflation in the first half of 1988 was no faster than it was during the same period in 1987. The current forecast estimates consumer price increases will register in the 4.5 to 5.0 percent range during the remainder of 1988 and into 1989.

Monetary Policy and Interest Rates

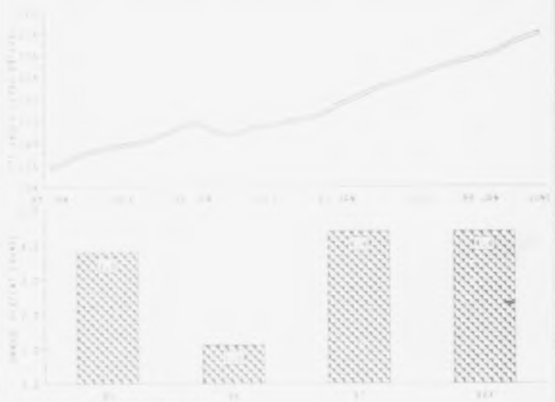
In his midyear report to Congress, Federal Reserve Board Chairman Alan Greenspan reconfirmed his commitment to control inflation. Mr. Greenspan indicated the Fed stands ready to nudge interest rates higher to slow economic growth in 1988 to forestall any acceleration in the rate of inflation. He suggested a GNP growth target of 2.7 to 3.0 percent was in line with the economy's "long run potential," but lower than the 3.3 percent GNP growth rate of the first half of 1988. Indications are that the Fed has already tightened credit considerably. Graph 6 illustrates the effects of this recent tightening, where rising short-term interest rates have caused a gradual flattening of the yield curve.

GRAPH 4: HIGH CONSUMER INDEBTEDNESS PROMISES MODERATE CONSUMER SPENDING



SOURCE: Bureau of Economic Analysis

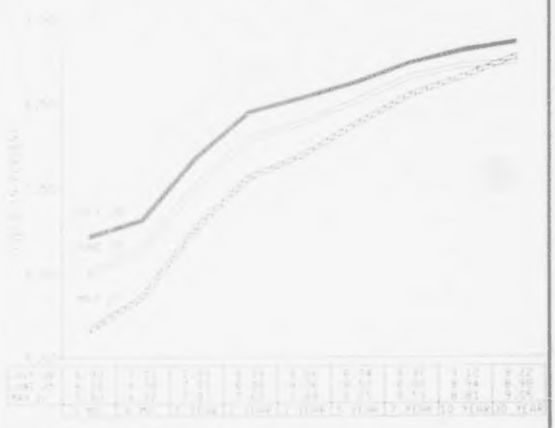
GRAPH 5: INFLATION REMAINS UNDER CONTROL



•SIX MOUNTH AVERAGE ENDING IN JUNE

SOURCE: Bureau of Labor Statistics

GRAPH 6: THE YIELD CURVE



SOURCE: Federal Reserve Board

The Federal Reserve has not, however, been alone in its move towards a tighter credit policy. In fact, the Fed has been joined by all the central banks of Western Europe and Japan. Much of this has been in keeping with a concerted effort by the foreign central banks to halt the recent rise of the dollar; which rose 8% against the mark and 7% against the yen between June 14th and July 15th. But, extremely large short-term interest rate hikes in both Germany and Britain have been influenced by domestic concerns as well. In Germany, the Bundesbank has increased rates substantially in an attempt to slow the outward flow of capital. The British central bank has actually pushed short-term rates higher than the long-term government bond yields in the hope of slowing domestic consumption in order to eventually shrink the British trade deficit. Regardless of the reasons, short-term credit has become more dear around the globe, narrowing the gap between short-term and long-term rates, and contributing to a general flattening out of yield curves internationally.

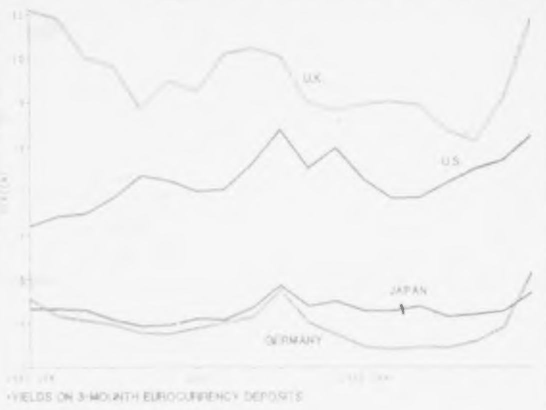
In reacting to rising rates of inflation by increasing short-term interest rates, the Fed has, to some extent, validated the inflationary concerns of the financial markets. In turn, longer-term interest rates, which are very sensitive to changes in expectations regarding inflation, have increased as well. While the anti-inflationary actions by the Fed and an encouraging consumer price index may have taken some of the pressure off the trend toward higher long-term rates, the mixed blessing of an overheating economy helps keep the pressure on. Thus, mortgage rates could continue to rise through the rest of this year to 11.1 percent in the fourth quarter, before leveling off in 1989 at about 11.4 percent.

REAL ESTATE MARKETS

Housing Starts

Starts of privately owned housing units reached a seasonally adjusted annual rate of 1.454 million units in June, 5 percent above the May annual rate of 1.384 million units. The June 1988 annual rate was 8.1 percent slower than the June 1987 annual rate of 1.583 million units. Single-family units were started at an annual rate of 1.098 million units, 10 percent faster than the May annual rate of 996 thousand units. However, a decline in the annual rate for starts of multi-family units offset part of the advance in the pace of single-family starts. Specifically, multi-family starts with five or more units fell from an annual rate of 327 thousand units in May, to an annual rate of 296 thousand units in June. Starts of multi-family units with 2-4 units reached an annual rate of 60 thousand units, virtually unchanged from the May annual rate of 61 thousand units. Putting aside annual rates, during the first six months of this year, 738,900 housing units were started, an 11 percent decline from the 829,200 units total for the same period in 1987. However, the continuation of very high rates of employment and slowly rising interest rates should help keep housing starts near a level of 1.4 million units through the end of 1988.

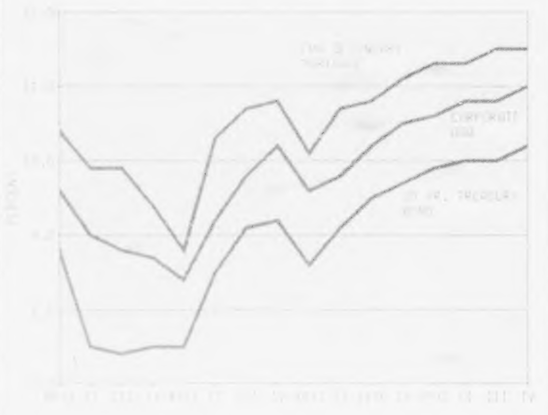
GRAPH 7: SHORT-TERM RATES ARE RISING



*YIELDS ON 3-MONTH EUROCURRENCY DEPOSITS

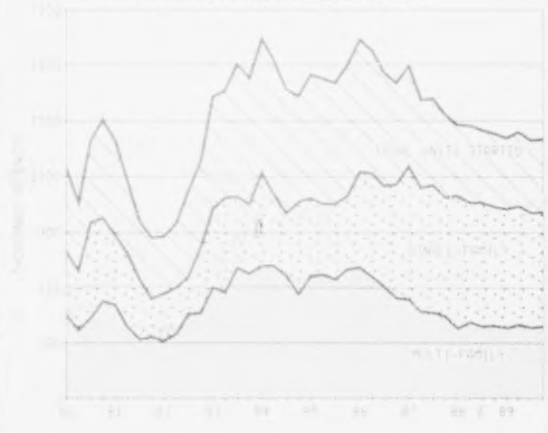
SOURCE: International Monetary Fund and The Economist

GRAPH 8: LONG-TERM INTEREST RATES



SOURCE: THE FEDERAL RESERVE BOARD

GRAPH 9: HOUSING STARTS



SOURCE: BUREAU OF CENSUS & NAR ESTIMATES

New Home Sales

Sales of new single-family homes surged to their fastest annual rate of the year, reaching a seasonally adjusted annual rate of 734 thousand units in June. This marked an 8.4 percent gain over the May annual rate of 677 thousand units. With the exception of a slight pause in May, the annual rate of new single-family home sales has increased in every month since December 1987. But the national number for June new home sales covers up large differences in the pace of home sales among the different regions of the country. In the Northeast, new home sales surged 15.5 percent to reach an annual rate of 119 thousand units, while in the West new home sales advanced 28.9 percent to an annual rate of 245 thousand units. Alternatively, new home sales in the South crept up only 4.2 percent to an annual rate of 273 thousand units, while in the Midwest new home sales showed little change at an annual rate of 97 thousand units. During the first half of the year, a total of 364 thousand transactions were recorded, down 3.5 percent from the same period in 1987. During the remainder of 1988, the annual rate of new home sales is expected to average 630 thousand units.

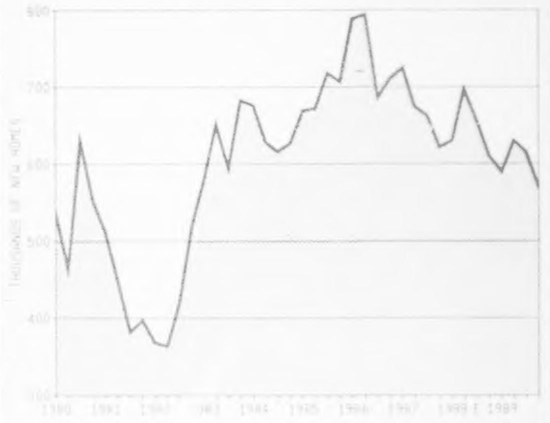
Existing Home Sales

In June, sales of existing single-family homes reached an annual rate of 3.78 million units, a gain of 5.3 percent over the May annual rate of 3.59 million units. This marked the fifth consecutive monthly advance in the annual rate of existing home sales. Furthermore, for the first time in 12 months, existing home sales were sold at a faster pace than the year earlier period. The June 1988 annual rate was 5.6 percent faster than the June 1987 sales pace of 3.58 million units. By region: June sales of existing single-family homes reached 700 thousand units in the Northeast (down 2.8 percent from 720 thousand); sales in the Midwest reached 1.0 million units (up 8.7 percent from 920 thousand); sales in the South reached 1.43 million units (up 9.2 percent from 1.31 million); and sales in the West reached 690 thousand units (up 7.8 percent from 640 thousand). Sales volume in all regions equalled or surpassed the June 1987 pace. Putting annual rates aside once more, existing home sales totaled 1.756 million units during the first six months of this year, 3.6 percent below the 1.822 million homes total of the first half of 1987. The second half of this year will still exhibit considerable strength in existing home sales. With economic growth expected to continue due to export growth and business fixed investment, the expected modest rise in interest rates will likely encourage many potential homebuyers to purchase homes earlier than they had planned.

Home Prices Continue to Advance Strongly

The median price of an existing single-family home rose to a new high of $90,600 in June, 2 percent above the May median price of $88,800 and 5.5 percent higher than the June 1987 median price of $85,900. The June median price for new single-family homes reached $117,800, a 7.1 percent gain over the May median price of $110,000 and 8.1 percent higher than the June 1987 median price of $109,000. Faster rates of inflation in the coming months and continued strong housing demand will likely keep home prices advancing faster than the rate of inflation.

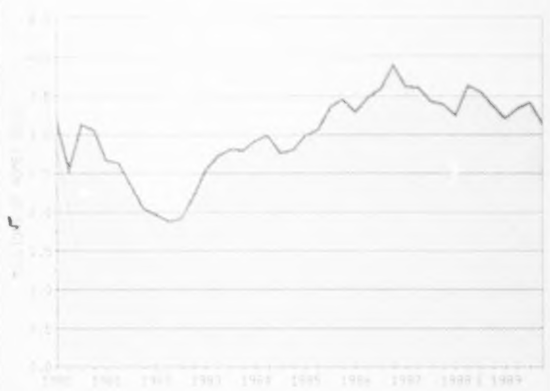
GRAPH 10: NEW HOME SALES



SOURCE: BUREAU OF CENSUS; E NAR ESTIMATES

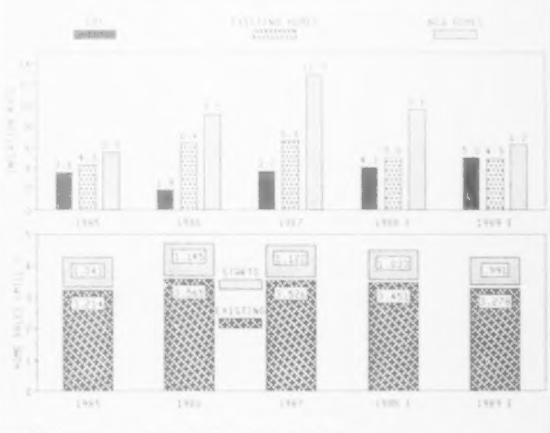
GRAPH 11: EXISTING SINGLE-FAMILY HOME SALES

(SEASONALLY ADJUSTED ANNUAL RATES)



SOURCE: NAR ECONOMICS AND RESEARCH; E NAR FORECASTING & POLICY

GRAPH 12: HOME PRICES



NOTE: New home total equals 97% of single-family starts.

Obstacles to Becoming a First-Time Homebuyer: A Look at NAR Survey Data

Introduction

Since its 1980 peak of 65.6 percent, the homeownership rate has fallen to 64.0 percent in 1987. The decline for younger households has been much more acute: a decline of 7.4 percentage points for 25 to 29 year olds (43.3 to 35.9 percent) and a decline of 7.9 perecntage points for 30 to 34 year olds (61.1 to 53.2 percent). [See Chart 1]. These age groups have historically encompassed the bulk of first-time homebuyers.

The falling homeownership rate for younger households has been attributed to reduced housing affordability--higher real house prices, higher user cost of housing, lagging incomes, etc. It seems reasonable to connect one with the other, but it is instructive to analyze the attitudes and housing decisions of younger households directly to make the connection explicit. That is, are younger renters foregoing (or delaying) homeownership because they want to or because they must?

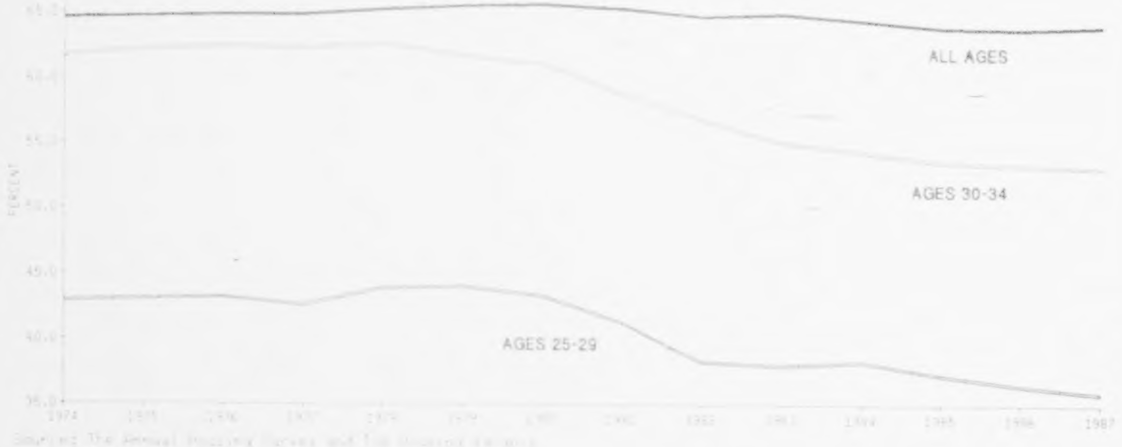
A special NAR survey of households allows us to compare the characteristics and attitudes of younger first-time homebuyers--those that have overcome the barriers to entering homeownership--with those who are yet renters (i.e., who have never owned). The evidence strongly shows that most younger renters (who have never owned) remain renters due to the financial burdens of attaining ownership.

Still Part of the "American Dream?"

Based on the results of several nationwide polls, homeownership still constitutes a primary component of the "American Dream." In a 1988 poll for the National Housing Institute, two-thirds of those under the age of 35 who do not own a home consider buying a home an important goal, and 17 percent regard it as their most important personal goal.

Similar attitudes appear in the NAR homeownership survey. To assess the future directions and prospects for homeownership, NAR conducted a nationwide survey in late 1986.[1] Over three thousand (3,254) households responded, 83 percent indicating that owning a home was indeed part of the "good life." But of those 83 percent, over one-quarter of the households had never owned a home.

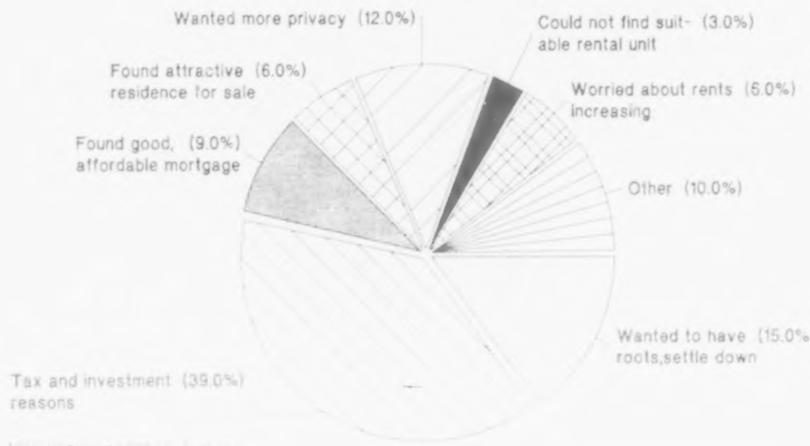
CHART 1: HOMEOWNERSHIP RATE



Sources: The Annual Housing Survey and The Housing Vacancy Survey, Bureau of the Census.

CHART 2: THE HOME PURCHASE DECISION

Primary Reasons Given By First-time Homebuyers Under Age 40



Source: 1986 NAR Homeownership Survey.

The reasons that first-time homebuyers under age 40 give for buying their homes offer clues into the desirable features of homeownership. [See Chart 2]. To many, homeownership is associated with stability, with 15 percent of young first-time homebuyers indicating that their primary reason for buying is to settle down and establish roots. Additionally, 39 percent indicated tax or investment benefits, and twelve percent noted the demand for privacy as their primary reasons for wanting to attain homeownership.

Many renters will seek single-family detached housing (and homeownership) when they begin planning a family. About two-thirds of owners and one-half of renters in the NAR survey "agree a lot" (and another 20 percent "agree") that it is important to have a yard for private use. Households agree even stronger that a private yard is important if children are present; about 70 percent of both owners and renters "agree a lot", and over 90 percent at least "agree." Thus, the evidence indicates that homeownership satisfies important personal and investment needs.

The First-Time Homebuyer - Obstacles to Homeownership

In the past few years, the road to homeownership for the first-time homebuyer has never been rockier. The financial obstacles to attaining homeownership have become more severe.

- **Real Housing Prices Have Risen.** Real house prices (new constant-quality home) surged 27.5 percent between 1971 and 1979. Whereas real house prices actually declined 4.9 percent between 1979 and 1985, they remain high by historical standards.
- **Homeownership Costs Have Risen.** The after-tax cash cost of homeownership (mortgage interest, utilities, maintenance and repair, insurance, and property taxes, less income tax savings) is currently well above its level during the 1960s and early 1970s. The slowdown in house price appreciation in recent years (in most areas) has diminished the investment motivation for homeownership.
- **Real Interest Rates Are Higher Now.** The high market interest rates of the early 1980s have declined, but inflation has fallen by more, so real borrowing cost (i.e., the market interest rate less inflation) remains high by historical standards. While the availability of adjustable rate mortgages has helped many households obtain lower initial rates, real rates nevertheless remain high.
- **Affordability Has Worsened.** Increases in household income have lagged increases in home prices, making house payments less manageable for the bulk of the population. In 1986, the ratio of the median price of a single-family house to the median household money income was 2.75. This is well above the ratios of the early 1970s, which were typically between 2.30 and 2.40.
- **Up-front Costs Are More Difficult To Meet.** The required downpayment has skyrocketed with the prices of homes. With savings squeezed by rising prices, especially rents (real contract rents rising 16 percent in 1987 from their low in 1981), the accumulation of a downpayment through household savings has become increasingly difficult. Furthermore, the closing costs require an additional several thousand dollars up-front.
- **Transactions Costs Are High.** Many younger households are quite mobile, e.g., expecting moves for employment and other reasons. Thus, it can be costly for them to buy and then relocate shortly thereafter.

Attaining Homeownership

Who are the households that are overcoming these obstacles to homeownership? Where are they getting their downpayment? Do these first-time homebuyers differ substantially from the remaining renters? The results of the NAR survey can help answer these questions.

From the NAR survey data, it is possible to distinguish between those renters who have never owned and current renters who have owned before. The latter group are likely those who are only temporarily renting, e.g., due to a job transfer. The former group we can term "potential" first-time homebuyers. Thus, we compare the characteristics of first-time buyers to those renters who have never owned. For the purposes of this analysis, a "first-time homebuyer" is a household that bought their current home (their first home) in 1984, 1985 or 1986 (survey taken in November 1986). Moreover, we confine the following analysis to households below 40 years old (which includes most of the first-time homebuyers) in order to control for differences in income, etc., that are due strictly to age.

Not surprisingly, first-time homebuyers have greater incomes than those who have never owned, but less income than other, more "seasoned" owners (below 40). The median income (in 1984) of first-time homebuyers is $23,200, while for other owners it is $25,900 and for renters (who have never owned) it is only $15,300. Of these "potential" first-time owners, 31 percent have incomes below $10,000, while only eight percent of the first-time buyers do. Most of these low-income renters, then, are far from being "potential" first-time buyers.

Marital status also differs among these groups. Fifty-eight percent of the first-time buyers are married couples, nearly as high as other owners (64 percent). Only 34 percent of the remaining renters are married couples. Thus, renters with sufficient incomes who have a more "stable" household pattern, i.e., married couple, are more apt to become owners.

Renters who are close to being first-time buyers are those who have never owned and who "seriously considered" owning at their last move. Even for these renters, insufficient financial resources dominate as reasons for not becoming owners. Nearly 90 percent of these renters cited that their inability to obtain the necessary downpayment was one of their reasons for renting; and 44 percent gave this as their *primary* reason for renting. One-third also noted insufficient money for closing costs as one reason for renting. Moreover, over one-third of these renter households said that high mortgage rates were a reason for choosing to rent, and nearly one-half cited high house prices. Chart 3 shows the distribution of these renting households by their *primary* reason for choosing to rent.

The Downpayment and Household Savings

The NAR survey shows that the overwhelming majority of households below 30 years of age save little in financial assets. That is, 72 percent of these younger households save less than five percent of their income in financial assets, and 45 percent save less than one percent.

When they do eventually accumulate a sufficient amount of savings, many of them purchase a home and convert this liquid wealth into relatively illiquid home equity. The average downpayment of first-time homebuyers (under 40) in the NAR Survey is $8600. Of that, an average of $5500, or 64 percent, comes from savings. Loans constitute an average $1200, or 14 percent. An average of only $800, or 9 percent, comes from gifts (from relatives). Obviously, repeat homebuyers can--and do--rely on accumulated home equity for most of their downpayments. [See Table 1].

Conclusion

The evidence suggests that most households desire homeownership and would like to attain it. While very low-income households will have severe difficulties in overcoming the financial barriers to attaining homeownership, it is within reach for many others. The main obstacles that renter households (who have the incomes and other characteristics that truly make them "potential first-time homebuyers") face is the accumulation of the downpayment and closing costs. Consequently, business or government programs and policies geared to assisting renters in overcoming this obstacle may be quite fruitful for making homeownersip attainable.

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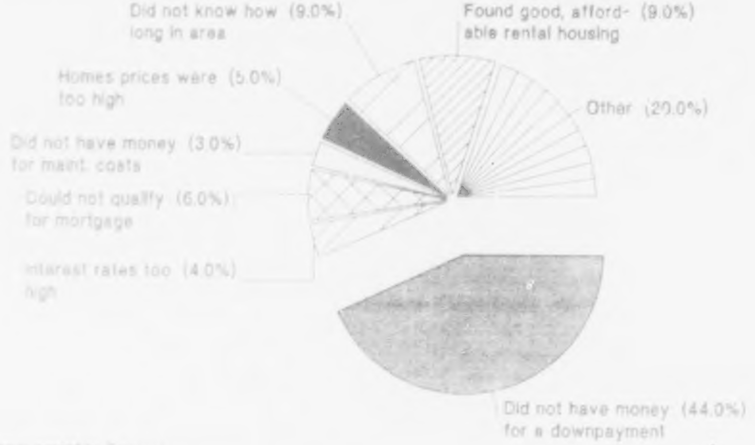
[1] The survey contained questions about: 1) the condition of the household's current and prior dwelling units and neighborhoods; 2) the household's expected future mobility; 3) the impact of tax changes on the decision to purchase; 4) the cost of housing and method of financing (for owners); 5) household savings, including percent of income saved, and source and intent of savings; 6) the household's involvement in political, community and church activities; and 7) the household's attitudes about homeownership and citizenship.

by
Daniel N. Chambers
Director of Housing Research
and
Mary B. Schwartz
Housing Economist

CHART 3: WHY RENT?

Primary Reasons Given By Prospective First-time Homebuyers



Source: 1988 NAR Homeownership Survey

Table 1

SOURCE OF DOWNPAYMENT

	First-Time Homebuyers		Repeat Homebuyers	
	Avg. $ amount from:	% of Total Downpayment	Avg. $ amount from:	% of Total Downpayment
Savings	$5,553	64%	$4,369	25%
Equity from previous home	0	-	10,573	61
Refinance of investment property	0	-	216	1
Gift from relatives	797	9	339	2
Loan from relatives	1,229	14	547	3
Life insurance	26	-	227	1
Other	1,051	12	1006	6
Total	8,656	100%*	17,277	100%*

*May not add to exactly 100% due to rounding

SIGNIFICANT REAL ESTATE-RELATED TECHNICAL CORRECTIONS

Technical Corrections Update

On July 14, 1988 the House Ways and Means Committee reported the Technical Corrections Act (TCA) to the full House. The House is expected to begin debate of the bill August 4th, where approval is likely.

The Senate Finance Committee, chaired by Lloyd Bentsen, began and completed its markup of the bill on July 26. In light of the selection of Senator Bentsen as the Democratic Vice Presidential candidate, the bill reported out of the committee is "clean". It does not contain as many of the revenue raising amendments nor any of the extensions of expiring provisions the House bill contains. It is possible that these provisions will be added to the bill on the Senate floor either separately or as a package. Differences between the House and Senate versions of TCA will need to be reconciled in conference before both Houses recess for the fall elections.

The Mortgage Revenue Bond and Mortgage Credit Certificate Programs

The House version of the bill extends the Mortgage Revenue Bond (MRB) and Mortgage Credit Certificate (MCC) programs until the end of 1990 and made the following modification to those programs.

- An income limitation of 115 percent of area median income would apply to families of three or more. For other households, the income limitation would be 100 percent of area median income.
- Special adjustments to the income limitations for nontargeted areas would apply in areas having significantly high or low ratios of housing costs to area incomes when compared to national norms.
- Issuers of qualified mortgage bonds and qualified veterans' mortgage bonds would be required to rebate arbitrage profits to the Federal Government under the rules that now apply to issuers of other private activity bonds.
- A three-year loan-origination period would be imposed for qualified mortgage bonds. Unspent proceeds and prepayments must be used to redeem bonds.
- An amount equal to the special subsidy provided by qualified mortgage bond-financing or an MCC (but not in excess of 50 percent of the total gain) would be recaptured on disposition of the house.
- Full recapture of this special subsidy would occur if the dwelling were sold within 5 years; recapture would phase-out in years 6 through 10.
- A special rule would exclude from recapture part or all of the special subsidy in the case of participants whose incomes were less than prescribed amounts at the time of the disposition. The recapture provision would not apply in the case of home improvement loans.

Recapture generally would apply to financing provided and MCCs issued after December 31, 1988. Borrowers receiving loans after that date also would be exempt if loans were made pursuant to binding contracts with homebuilders, lenders, or borrowers entered into before June 23, 1988, and if the bonds were either (a) issued before that date, or (b) issued before August 1, 1988, pursuant to applications for state bond volume authority made before July 1, 1988. (see *Real Estate Outlook*, July 1988).

The Low-Income Rental Housing Tax Credit

The House bill also provides an extension of the Low-Income Rental Housing Tax Credit (LITC) which was due to expire at the end of 1989. This provision will sunset at the end of 1990 if the House version is enacted into law.

How the Program Works

A rental housing project is eligible for the tax credit if either: a) 20 or percent more of the units are occupied by individuals who have incomes of 50 percent or less of the area median income; *or* b) 40 percent or more of the units are occupied by individuals who have incomes of 60 percent of the area median income. The income standard is adjusted for family size.

The gross rent charged to the families in these units can be no greater than 30 percent of the monthly qualifying income. The incomes of the tenants are verified on an annual basis to check for compliance; however, a special provision allows individual tenants who qualified when they first occupied the unit to continue to qualify even if their income increased beyond the maximum qualifying income level.

State Credit Limits

Congress has placed annual limits on the amount of tax credits which each state may authorize. The limit is set at $1.25 per state resident for the previous year. This creates a nationwide limit of about $300 million on the program. The project will receive the credit the year it is placed into service not the year construction begins. Presumably, the project could secure a commitment of credits before the project is started. These commitments will depend upon the amount of prior commitments, the state's credit cap, and the state's authority to issue credits at the projected completion of the project.

The Credit Amount

The amount of the credit that a project receives depends upon the type of project and the type of other federal assistance received. For projects placed in service in 1987:

- Expenditures for new construction, but not acquisition costs, are eligible for a nine percent credit against total expenditures for qualifying units. Rehabilitation costs of existing housing are treated in this same manner.
- New construction and rehabilitation expenditures which are financed by subsidized federal loans or tax-exempt bonds are eligible for a four percent credit. However, community or urban development grants are not treated as a federal subsidy.
- Costs of acquiring an existing housing project, whether federally assisted or not, are eligible for a four percent credit. The project must have been placed in service more than ten years prior to the current acquisition.

Probably the most complex aspect of using this credit involves the change made for projects placed in service after December 31, 1987. The nine percent credit discussed above will be changed such that the amount of the credit each year will remain equal but the present value of the credits will equal 70 percent of the project's depreciable basis. This present value will depend upon the prevailing market interest rates. As interest rates increase, the credit percentage will increase so that the present value will always be 70 percent of the basis. Similarly the four percent credits will adjust to allow the present value of the credit over ten years to equal 30 percent of the project's depreciable basis. This provision is intended to insulate the value of the credit from any changes in interest rates.

Recapture of Credits

The credits are received over the first ten years of the housing project's service even though the project must continuously meet compliance standards for 15 years. In essence, the credit is a 15 year program "accelerated" to a ten year payout horizon. Thus if a specific project fails to comply due to excessive vacancies in low-income units or above standard income levels of individuals in these units, then the "accelerated" portion of the credits is recaptured with interest. A sale of the project can also cause a recapture of the credits unless the compliance period has been completed or a bond is posted with the Treasury by the seller to guarantee compliance for the remainder of the 15 years.

Incentives for Individual Investors

Income from these projects will be subject to the passive activity loss limitations as would income from other rental property. Two exceptions are made:

- Limited partners as well as "active participants" may use the $25,000 exception from loss limitation for these projects. This loss limit is equivalent to $7,000 in tax credits per investor.
- This exception will phase out at income between $200,000 and $250,000 instead of between $100,000 and $150,000 for most rental real estate. Unused credits may be carried forward and used to offset gain at time of sale but any unused credits beyond that amount are forfeited.

As a consequence, investors and their property managers and accountants will thus have to track many different project characteristics to determine a project's potential return. Since these items may be difficult to project for the 10 year credit period, the project itself will be difficult to value.

Future of the LITC

The difficulties discussed above plus the uncertainty over the continuation of the tax credit and other changes in the tax code have resulted in limited use of the credit. An article in the July 19, 1988 issue of the *Wall Street Journal* suggests that only 50 to 60 percent of the $300 million overall allotment of credits will be used in 1988. Some authorities quoted in the article feel that the number of program requirements is discouraging individual investors. Other experts feel that the program needs time to "catch on" in the private marketplace. They feel it should be extended beyond the December 31, 1989 sunset date to allow developers time to organize and implement these projects.

Additional Real Estate-Related Proposed Tax Changes

The House Ways and Means Committee bill also contains three minor provisions relating to real estate:

- *Capital Gains Rollover for a Surviving Spouse.* Present law provides a rollover of the capital gain on a taxpayer's principal residence if the taxpayer reinvests the sale price of the old residence in a new principal residence within two years. The Committee agreed that the rollover would be available in situations where one spouse dies after the sale of the old residence and before the date of the purchase of the new residence. The provision would apply to the sale of an old residence by the surviving spouse after December 31, 1984.
- *Special Use Valuation of Farm Property for Estate Tax Purposes.* A surviving spouse's cash rental of specially-valued real property to qualified heirs would not result in the property failing to be treated as still used in a qualified use for purposes of the special use valuation recapture tax.
- *Multifamily Rental Housing Bond Restrictions Applicable to Certain Obligations of Section 501(C)(3) Organizations.* The Committee agreed to extend the private, for-profit low-income tenant occupancy requirements to qualified residential rental property financed with qualified 501(c)(3) bonds. A property financed with governmental bonds would be treated as a non-purpose investment under the Tax Code arbitrage rules if it were located outside the jurisdiction of the governmental unit issuing the bonds. These provisions would apply to bonds issued after July 14, 1988.

Update on UBIT

The unrelated business income tax (UBIT) issue remains in legislative limbo in the Ways and Means Oversight Subcommittee and is likely to stay that way throughout this year. The June 23 staff recommendations on UBIT, which reflect subcommittee decisions made in May, are a move toward resolving problems of competition between nonprofit organizations and the small business community. However, the recommendations do not address many of the members' specific concerns and thus have not generated the support necessary to be forwarded to the full committee.

Oversight Subcommittee Chairman J.J. Pickle had hoped to send a final package to the full committee before the Fourth of July recess. He indicated in a letter that accompanied the recommendations that the subcommittee members would meet one more time during the last week of June to discuss the recommendations before voting on them. However, no meeting has been scheduled, in part because the full committee markup of technical corrections legislation took longer than expected. This delay has the advantage of keeping the UBIT issue separate from the revenue-raising discussions

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Sources: "UBIT Recommendations Likely To Remain in Limbo This Year", *Tax Notes* July 25, 1988 pp. 328-330.

"Senate Panel Approves Bill To Fix Errors in '86 Tax Law," *The Washington Post*, July 27, 1988, p. F12.

"The Low-Income Rental Housing Credit," Douglas B. Diamond, Jr., *Home Building After Tax Reform: A Builder's Guide* National Association of Home Builders, November 1986.

U.S. ECONOMIC OUTLOOK

	QUARTERS								YEARS				
	ACTUAL		FORECAST						ACTUAL		FORECAST		
	1988.1	1988.2	1988.3	1988.4	1989.1	1989.2	1989.3	1989.4	1986	1987	1988	1989	1990
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4725	4807	4894	4974	5057	5142	5213	5284	4240	4527	4850	5174	5497
% Change	5.4	7.2	7.5	6.7	6.8	6.9	5.7	5.5	5.6	6.8	7.1	6.7	6.2
% Change (w/out inflation)	3.4	3.1	3.2	2.6	2.3	2.7	1.7	1.9	2.8	3.4	4.0	2.5	2.1
Consumer Price Inflation (CPI)	3.4	4.8	4.7	5.1	5.3	5.3	4.8	4.3	1.9	3.7	4.1	5.0	4.7
GNP Inflation (GNP Deflator)	1.7	4.1	4.1	3.9	4.4	4.1	3.9	3.6	2.7	3.3	3.0	4.1	4.1
Unemployment Rate - Civilian	5.7	5.4	5.3	5.1	5.1	5.1	5.2	5.2	7.0	6.2	5.4	5.2	5.4
Civilian Employment-Household Basis (millions)	114.2	114.6	115.4	116.0	116.4	116.9	117.2	117.5	109.6	112.4	115.1	117.0	118.3
Percent change	2.6	1.5	2.7	2.2	1.3	1.5	1.1	1.1	2.3	2.6	2.3	1.7	1.1
Index of Industrial Production	134.5	136.0	137.4	138.6	138.9	139.5	139.6	140.0	125.1	129.8	136.6	139.5	141.6
Manufacturing Capacity Utilization	82.7	83.1	83.4	83.5	83.6	83.8	83.6	83.5	79.7	81.0	83.2	83.6	83.4
Domestic Auto Sales	7.6	7.5	7.4	7.3	7.3	7.2	7.1	7.1	8.2	7.1	7.4	7.2	7.1
Federal Tax Receipts (NIPA) as % of GNP	20.1	20.5	20.2	20.2	20.3	20.3	20.3	20.3	19.5	20.2	20.3	20.3	20.9
Federal Expenditures (NIPA) as % of GNP	23.4	23.0	22.9	23.0	23.1	23.0	23.0	22.9	24.4	23.7	23.1	23.0	22.9
Deficit(NIPA)	-155.1	-118.8	-133.5	-135.7	-141.5	-135.1	-139.4	-136.0	-205.6	-157.8	-135.8	-138.0	-109.0
as % of GNP	-3.3	-2.5	-2.7	-2.7	-2.8	-2.6	-2.7	-2.6	-4.9	-3.5	-2.8	-2.7	-2.0
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4314	4660	4579	4382	4205	4350	4389	4132	4712	4648	4484	4269	4214
Percent change -- year ago	-10.1	-0.8	1.1	-1.5	-2.5	-6.7	-4.2	-5.7	10.8	-1.4	-3.5	-4.8	-1.3
Existing Single-family Home Sales ($1000)	3250	3630	3550	3375	3210	3340	3410	3150	3565	3526	3451	3278	3205
Percent change -- year ago	-10.1	0.6	3.5	-0.4	-1.2	-8.0	-3.9	-6.7	10.9	-1.1	-2.1	-5.0	-2.2
Housing Starts (thousands)	1477	1474	1450	1432	1408	1439	1395	1401	1812	1634	1458	1411	1449
Percent change -- year ago	-17.0	-8.2	-10.4	-6.6	-4.6	-2.4	-3.9	-2.1	4.1	-9.8	-10.8	-3.2	2.7
Single-Family Units	1097	1062	1061	1038	1026	1042	1009	1012	1183	1157	1065	1022	1041
Percent change -- year ago	-11.9	-6.6	-8.1	-4.7	-6.4	-1.9	-4.9	-2.5	10.4	-2.2	-8.0	-4.0	1.8
Multi-Family Units	380	412	390	394	382	398	385	389	630	477	394	389	408
2-4 Family Units	56	60	56	57	55	58	56	56	85	66	57	56	59
Percent change -- year ago	-29.0	-17.1	2.0	1.2	-1.7	-3.4	-1.1	-1.2	-9.0	-22.6	-12.7	-1.9	5.1
5+ Family Units	324	352	333	337	327	340	330	333	545	412	336	332	349
Percent change -- year ago	-28.7	-11.2	-18.6	-13.0	1.0	-3.4	-1.1	-1.2	-5.6	-24.4	-18.3	-1.2	5.1
New Single-family Home Sales (thousands)	630	697	657	610	590	630	615	570	750	671	649	601	550
Percent change -- year ago	-12.9	3.4	-2.7	-1.8	-6.3	-9.6	-6.4	-6.6	9.0	-10.5	-3.4	-7.3	-8.5
Mobile Homes Shipped (thousands)	207	215	212	213	206	210	206	207	246	233	212	207	216
HOME PRICES													
Existing Home Prices - Median $(1000)	87.8	88.9	91.2	91.6	92.2	94.3	94.9	95.6	80.3	85.6	89.9	94.3	99.3
Percent change -- year ago	4.2	4.5	6.7	7.8	5.0	6.1	4.1	4.4	6.4	6.6	5.0	4.9	5.4
New Home Prices - Median $(1000)	112.9	112.9	114.5	115.5	117.0	121.0	122.5	123.7	92.0	104.0	114.0	121.1	126.0
Percent change -- year ago	16.0	9.1	7.8	3.3	3.6	7.1	7.0	7.1	9.1	12.9	9.6	6.2	4.1
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year FRM (FHA Secondary)	10.1	10.7	10.8	11.1	11.3	11.4	11.4	11.4	9.9	10.2	10.7	11.4	11.2
1-year ARM (without buydown)	7.5	7.6	7.6	7.8	8.1	8.2	8.2	8.3	7.9	8.2	7.6	8.2	8.0
30-year Corporate AAA Bond Rate	9.6	9.8	10.2	10.5	10.6	10.8	10.8	10.9	9.0	9.4	10.0	10.8	10.5
30-year Government Bond Rate	8.6	9.1	9.5	9.7	9.9	10.0	10.1	10.1	7.8	8.6	9.2	10.0	9.7
Short-Term Interest Rates													
Federal Funds Rate	6.7	7.2	7.6	7.7	7.9	8.0	8.0	8.0	6.8	6.7	7.3	8.0	7.8
3-month T-Bill Rate	5.7	6.2	6.8	6.9	7.0	7.1	7.2	7.2	6.0	5.8	6.4	7.1	6.7
Prime Rate	8.6	8.8	9.3	9.4	9.5	9.7	9.8	9.8	8.3	8.2	9.0	9.7	9.6
Discount Rate	6.0	6.0	6.0	6.0	6.2	6.3	6.5	6.5	6.3	5.7	6.0	6.5	6.4
Value of the U.S. Dollar (Trade-Weighted Avg.)	90.0	90.4	95.6	93.2	90.0	87.1	85.2	84.0	112.3	96.9	92.3	86.6	82.8
Percent change	-9.4	1.7	24.9	-9.8	-12.8	-12.2	-8.8	-5.1	-21.6	-13.6	-4.8	-6.2	-4.4

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr. Frederick Flick, Sean Burns and Beth Maerz.

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REAL ESTATE OUTLOOK

Vol. 1, No. 9 *September 1988*

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The U.S. Department of Commerce reported that second quarter real GNP growth advanced at a revised annual rate of 3.3 percent, slightly faster than the 3.1 percent annual rate originally reported. In all, the rate of real GNP growth in the first half of 1988 was stronger than expected, but the composition of that growth is changing to reflect more reliance on exports and less on consumer spending.

- The June trade deficit widened to $12.5 billion, stalling the continued resurgence in U.S. exports. Much of the June increase lay in the capital goods component; rising imports and falling exports of capital goods attested to the large scale re-tooling effort underway at U.S. manufacturers. For the quarter, the trade deficit fell 14.9 percent to $29.94 billion, its lowest level in three years.

- The Federal Reserve Board remains firm on its commitment to keeping inflation from accelerating. The Fed has gradually tightened monetary policy, raising short-term interest rates by about 150 basis points. Long-term interest rates, influenced more by inflation expectations, could continue their upward climb through the end of 1988.

- Housing starts showed modest gains in July, rising 2.4% above the June annual rate of 1.454 million units to a seasonally adjusted annual rate of 1.489 million units. All of the July advance came from a resurgence in starts of multi-family structures with five or more units, which increased 18.7 percent to 362 thousand units.

- The seasonally adjusted annual rate of existing single-family home sales fell in July to 3.63 million units, down 5.0 percent from the revised June annual rate of 3.82 million units. The July annual rate was still 4.6 percent stronger than the July 1987 annual rate of 3.47 million units. The current forecast projects that rising mortgage interest rates and a slower rate of economic growth will slow the pace of existing home sales in the second half of 1988 to an annual rate of about 3.46 million units, and about 3.28 million units in 1989.

IN THIS ISSUE

- **Power to the People: Economic Commentary, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean Burns and Beth Maerz**
- **Depreciation of Real Property Under the Tax Code, by Kevin Yeats**

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POWER TO THE PEOPLE!

Economic Commentary

by
John A. Tuccillo
Chief Economist and
Senior Vice President
Real Estate Finance

As Sherlock Holmes was wont to say to his faithful colleague, "You look, Watson, but you do not see!" To a large degree, the alarms over inflation that have dominated the economic news this summer have been a prime example of Watson's Syndrome, the tendency to look without really seeing. Yes, the Fed acted absolutely appropriately (more about this later) in raising the discount rate to signal its displeasure with the economy. Yes, prices have become a bit more of a problem than they were earlier in this decade. Yes, unemployment has shrunk to levels that, as recently as ten years ago, have been accompanied by roaring inflation. But all these *transitory* factors ignore a fundamental truth about this economy: the longer term trends are toward higher employment, steady price growth and moderate interest rates.

It has been argued in this column that demographics are moving us toward the potential of an expanding economy through the end of the century. As George Will (one of our most insightful social philosophers -- even if he is a Cubs fan) has put it, "In a democracy, demography is destiny." We now have a population that is massing in the middle years -- those years of high employment, high productivity and high consumption. They are in fact a built-in engine of prosperity that will pull the American economy along. Over the next decade, we should see "standard" rates of both unemployment and inflation hover in the 4.5-5 percent range, with both having the potential to be even lower.But, to turn a phrase, that will be then, this is now. Are there inflationary pressures building in this economy? Alan Greenspan seems to think so. The Fed's conception of where the economy ought to be didn't square with where it actually was, and financial markets weren't cooling things off quickly enough. So, Mr. Greenspan took the economy to the woodshed and administered a quick, painful spanking. Sometimes that type of punishment works; it's clearly better than the lingering death that characterized economic policy in the Seventies. Because of the Fed's actions, interest rates will rise and the economy will slow. Inflation will recede and so will anxiety levels.

While the Fed's actions may have been necessary as a signal, in fact the threat of surging inflation was never really there for three basic reasons:

1.*Interest rates were rising anyway.* There is simply too much debt floating around in financial markets, and lenders were demanding higher return in order to absorb it. This would have slowed the economy even without Fed action.

2.*The economy is growing where there is slack.* The success story of 1988 is the Midwest. A plummeting dollar and resurgent industry has increased exports steadily for nearly two years. And the rust belt has been the beneficiary. So growth is coming at the point of least pressure.

3.*Demographics*. Besides the sheer numbers of people in their productive years, the economy is enjoying higher labor participation rates. As we pointed out last month, more and more families, both with and without children, are providing two (or more) workers to the labor force. So the problems tend to be shorter term in nature. Drought has given food processers and wholesalers a smokescreen to gouge the public; our appetite for imports adds elements of expense to the consumption mix; and in some sectors of the economy capacity pressures exist. But the fundamentals, to which every economy must eventually return, are pushing us towards greater productivity and lower inflation.

Housing benefits from these trends, as well. So far this year, we've seen much stronger sales activity than anticipated in virtually all sectors of the country. A great deal of this stems from sheer numbers. Those productive baby boomers are not only consuming VCRs, but they're buying houses. And our statistics suggest that they will continue to do so through the mid-90s, creating a strong housing market. But, as is the case with the general economy, short term concerns about housing production can obscure longer term reality.

The message here is that, like Watson, we tend to look without seeing. Ultimately, this economy will be shaped over the next decade by the qualities of its population. Nervous financial markets may place interest rates on a roller coaster (albeit a kiddie version), wise and foolish public policy may generate economic cycles, but the basic thrust of economic life is toward growth, productivity and stability. Is that good? Elementary, my dear Watson!

Outlook for the Economy and Real Estate

THE ECONOMIC OUTLOOK

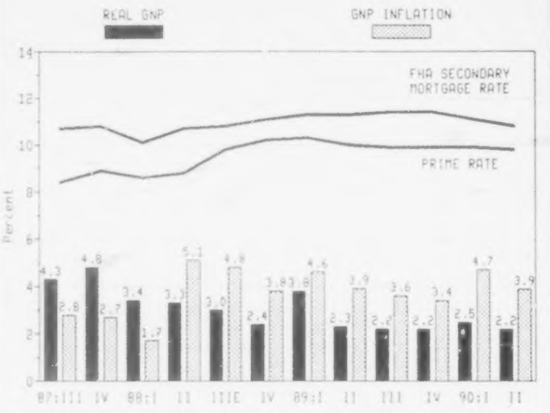
The U.S. Department of Commerce reported that second quarter real GNP growth advanced at a revised annual rate of 3.3 percent, just slightly faster than the 3.1 percent annual rate originally reported. The revised rate was virtually unchanged from the 3.4 percent annual rate of the first quarter. In all, the rate of real GNP growth in the first half of 1988 was stronger than expected, but the composition of that growth is changing to reflect more reliance on exports and less on consumer spending (more below). The strong first half has engendered even stronger concerns relating to the path of inflation in the second six months of 1988. In response, the Federal Reserve has spent the last few months trying to control the economy's seemingly boundless growth potential by raising interest rates about 1 and one-half percentage points. The most recent monthly indicators (though often the most erratic) suggest the Fed's actions are meeting with some success: retail sales softened, new orders were down, unemployment increased, and single-family housing starts and home sales have eased. Paradoxically, a slower second half of 1988 could improve the economy's growth potential in 1989.

Consumer Spending Retreats

While the recent GNP growth reports have heightened fears of accelerating rates of inflation, there is a comforting trend emerging in the composition of this real GNP growth. Much of the credit for the prolonged economic expansion of the 1980's is due to no other than the willingness to spend of the American consumer. Today, lagging personal income growth, the non-deductibility of sales taxes and personal interest charges are forcing more cautious spending habits. In addition, rising interest rates have increased the costs of credit cards, home equity loans and other lines of credit, all of which adds up to a U.S. consumer who is exercising some new found restraint. The neighboring graph shows the actual percentage point contributions to GNP growth by each sector. In 1988, consumer spending is expected to account for only 2.2 percentage points, down from 3 percentage points in 1985. Midway through 1988, exports appear poised to take up the slack: they are expected to contribute 1.4 percentage points to real GNP growth in 1988, compared to *minus* 0.9 percentage points in 1985. Also, business equipment spending to expand capacity will likely add 1.3 percentage points to real GNP growth in 1988.

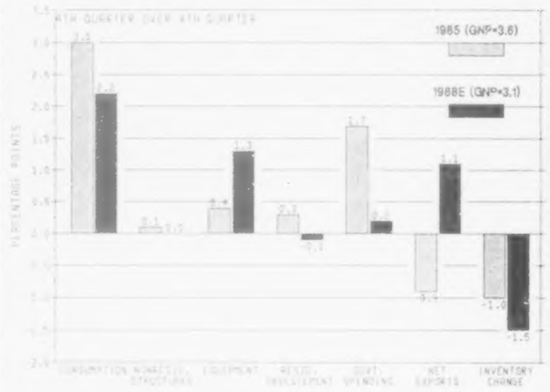
The June trade deficit widened beyond most expectations to $12.5 billion, seemingly thwarting hopes for a continued resurgence in U.S. exports. Part of the wider trade gap was due to a rise in imports of consumer goods, but another source of the June increase lay in the capital goods component: rising imports and falling exports of capital goods attested to the large scale re-tooling effort underway at many U.S. manufacturers. In short, domestic production of capital goods has had to be supplemented with capital goods imports. For the quarter, the trade deficit fell 14.9% to $29.94 billion, its lowest level in three years. Both the deficit and the dollar are expected to continue their decline through 1989 and into 1990, with the trade deficit falling to nearly half its 1986 peak by the end of next year.

GRAPH 1: THE ECONOMIC OUTLOOK



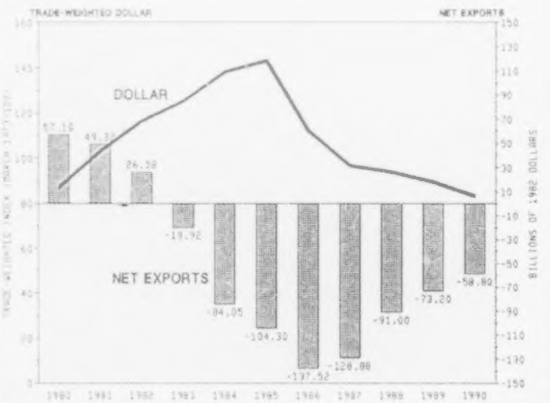
E NAR estimates(1988:III thru 1989:IV)

GRAPH 2: CONSUMPTION YIELDS TO EXPORTS



SOURCE: Dept. of Commerce, Bureau of Economic Analysis.

GRAPH 3: THE OUTLOOK FOR THE DEFICIT



SOURCE: BUREAU OF ECONOMIC ANALYSIS.

Wage Increases Remain Modest

Inflation continued to be the hot topic in August as analysts pointed to everything from the trade report to the GNP deflator as an indication that prices are preparing to spiral out of control. However, as capacity constraints and rising food costs nudge prices upward, pressure from higher wage demands, at a time of historically low rates of unemployment, has remained surprisingly modest. The recent rise in the employment cost index (ECI), which was up 4.6% in the second quarter from the year before, appeared to be one of the first indications that wages may be heading higher. But the ECI may have overstated the increase. First, much of the wage hike was the result of higher benefit costs which reflect the recent rise in Social Security taxes. While the rise took place in the first quarter, the year-over-year increases will still evidence the change until 1989. Second, the ECI does not take into account the labor productivity gains of the past year: averaging 2 percent in non-farm businesses and 3 percent in the manufacturing industries. When these productivity gains are accounted for, the unit labor cost index reveals that manufacturing employees actually incurred compensation *reductions* in 1987. Further, even with the second quarter wage gains, their compensation has increased by less than one percent so far in 1988. The message: employment costs are still being held under control by cost-concious businesses that want to avoid building in high wage increases to long-term contracts.

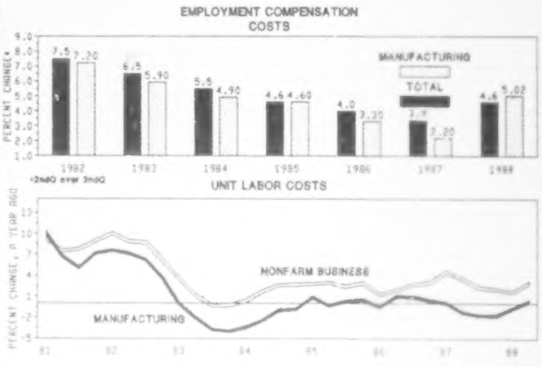
Monetary Policy and Interest Rates

Despite the public debate over how much inflation can be expected in the coming quarters, the Federal Reserve Board remains firm on its own intentions of keeping a lid on inflation. To this end, the Fed has already tightened up monetary policy, raising short-term interest rates by about 150 basis points. Raising interest rates always bears the risk of inducing a recession, but the Fed felt the evidence of an overheating economy was compelling: high employment, an improving trade balance, and capacity constraints being reached in many industries.

But the question remains whether the Fed believes its strategy of incremental rate increases has worked. The most recent set of monthly indicators suggests the Fed might be inclined to allow rates to plateau for a time. But the Fed probably will not place too much stock in any one month's set of statistics, preferring instead to err on the side of caution. This means that long-term interest rates, influenced more by inflation expectations, will likely continue to move up with short-term rates. The current forecast assumes the Fed will remain committed to battling inflation by raising interest rates. Consequently, interest rates are projected to continue their upward climb through the end of 1988, coinciding with annual rates of inflation nearing 5 percent.

However, if the next few months bring reports of slower economic growth, the Fed could adjust its policy stance. Specifically, if the annual rate of third quarter real GNP growth falls into the lower end of the Fed's target band of 2.5 to 3.0 percent, then an easier monetary policy could ensue. This, in turn, could move the interest rate plateau expected around the second quarter of 1989 up into the fourth quarter of 1988.

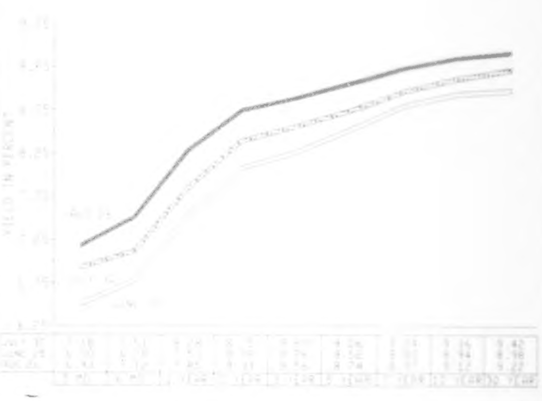
GRAPH 4: GAINS IN EMPLOYEE COMPENSATION



. . . ARE MARGINAL

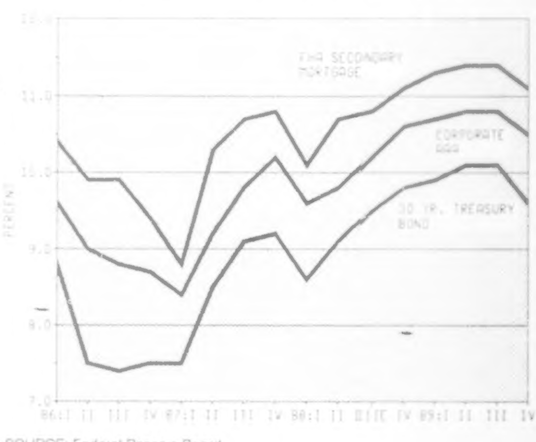
SOURCE: Bureau of Economic Analysis.

GRAPH 5: THE YIELD CURVE



SOURCE: Federal Reserve Board

GRAPH 6: LONG-TERM INTEREST RATES



SOURCE: Federal Reserve Board.

REAL ESTATE MARKETS

Housing Starts

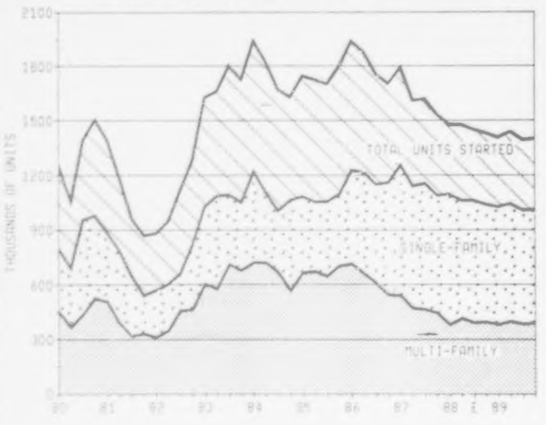
Housing starts showed modest gains in July, rising 2.4% above the June annual rate of 1.454 million units to a seasonally adjusted annual rate of 1.489 million units. However, the July figure reflects a drop of 6.5 percent from a year ago when housing units were started at an annual rate of 1.594 million units. All of the July advance came from a resurgence in starts of multi-family structures with five or more units, which increased 18.7 percent to 362 thousand units. The annual rate of starts of these units had fallen 9.5 percent in June and 22 percent in May. The reduction in backlogs for permit approvals assisted the increase for multi-family starts in July. Starts of privately owned single-family units fell slightly to 1.08 million units, 0.8 percent slower than June's annual rate of 1.089 million units and 5.4 percent below the July 1987 annual rate of 1.142 million units. Rising interest rates are beginning to take their toll on new residential construction.

Both the Northeast and the Midwest appear to be recovering from their depressed May levels, when total starts of privately owned housing units fell in these regions by 24.5 percent and 22 percent, respectively. Starts in the Northeast were up 9.1 percent in July to a seasonally adjusted annual rate of 262 thousand units, while starts in the Midwest rose 12.1 percent to an annual rate of 296 thousand units. After making slight gains in June, housing starts in the South and West fell slightly, dropping 1.2 percent in the South to a seasonally adjusted annual rate of 563 thousand units, and 3.2 percent in the West to an annual rate of 368 thousand units. Compared to one year ago, the Midwest is the only region where the annual rate of housing starts has increased, rising by a substantial 17 percent. In the other regions, the pace of housing starts fell 5.7 percent in the Northeast, 11.3 percent in the South and 14 percent in the West, relative to July 1987.

New Home Sales

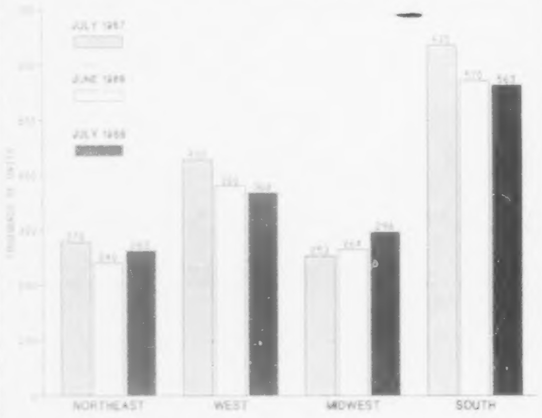
The seasonally adjusted annual rate of new single-family home sales slowed in July to 686 thousand units, down from June's impressive rate of 720 thousand units. The 4.7 percent drop marks the first significant decline in new home sales since the beginning of 1988, when sales began to climb after months of steady decline. Compared with the rate of home sales in July 1987, the news is a little brighter, with new home sales rising 2 percent above their year-ago annual rate of 672 thousand units. In the Northeast, following exceptionally strong sales rates in June, new home sales dropped 18.4 percent to an annual rate of 93 thousand units. Both the Midwest and the South experienced moderate slowdowns in single-family home sales, falling 5.4 percent in the Midwest to an annual rate of 86 thousand units and 4.9 percent in the South to an annual rate of 270 thousand units. In the West, where new home sales have been consistently strong this year, sales crept up by 2.2 percent to an annual rate of 237 thousand units, 24.1 percent above the July 1987 annual rate. New home sales are expected to slow through 1988, averaging an annual rate of 657 thousand units in this quarter and 610 thousand in the next.

GRAPH 7: HOUSING STARTS



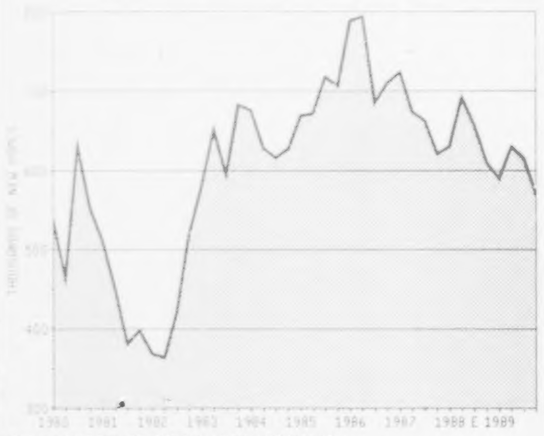
Source: Bureau of Census; E NAR Estimates

GRAPH 8: HOUSING STARTS BY REGION



Source: Bureau of Census

GRAPH 9: NEW HOME SALES



Source: BUREAU OF CENSUS, E NAR ESTIMATES

Existing Home Sales

Mirroring the trend evident in the single-family housing starts and new home sales data, the annual rate of existing single-family home sales fell in July by 190 thousand units to a seasonally adjusted rate of 3.63 million units. But, due to the strong growth throughout the first half of this year, the July rate was still 4.6 percent stronger than the annual rate of 3.47 million units experienced in July 1987. As with new home sales, July's 4.9 percent retreat in the rate of existing single-family home sales registered the first decline since December of last year. In fact, an annual rate of 3.63 million units is a very strong pace for existing home sales: the post-1982 housing recovery high is a 4.1 million unit pace set in December 1986. The decline was due in part to an expectation during May and June that mortgage interest rates were headed higher, thus moving some purchase decisions ahead by one to two months. The current forecast projects that rising mortgage interest rates and a slower rate of overall economic growth will slow the pace of existing single-family home sales in the second half of 1988 to an annual rate of about 3.46 million units, and about 3.28 million units in 1989.

Existing Home Sales By Region

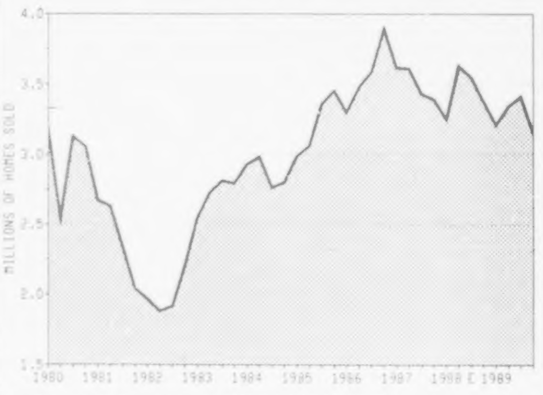
The drop in the rate of existing single-family home sales was felt across the country, with existing home sales falling in all four regions. In the Northeast, sales fell by 6.8 percent to a seasonally adjusted annual rate of 690 thousand units, down from the revised June annual rate of 740 thousand units. Sales in the Midwest slid 5.1 percent from the June annual rate of 990 thousand units to an annual rate of 940 thousand units. Existing home sales dropped 7.0 percent in the South, pushing the annual rate down to 1.32 million units from the June annual rate of 1.42 million units. In the West, the five month trend of steadily increasing sales finally took a breather, as sales fell 4.4 percent from an annual rate of 680 thousand units in June to an annual rate of 650 thousand units in July. However, as the neighboring graph illustrates, the annual rate of existing single-family home sales in all four regions was faster in July 1988 than it had been in July 1987.

Home Prices

The median sales price of an existing single-family home rose modestly in July to $91,600, 1.6 percent above the June median price of $90,200, and 3.7 percent above the July 1987 median price of $88,300. On a regional basis, the median home price in the South rose 2.1 percent to $85,600, and it fell 2.8 percent to $123,500 in the West. The median existing home price in the Northeast (-0.4 percent to $146,700) and Midwest (+0.9 percent to $70,600) remained relatively unchanged. Meanwhile, the median price of a new single-family home increased 5.6 percent in July to $123,500, which is 17.6 percent above the July 1987 median price of $105,000.

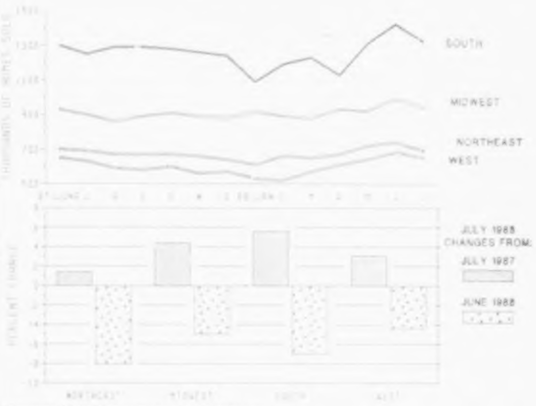
Sean Burns
Beth Maerz
Forecasting & Policy Analysis Division

GRAPH 10: EXISTING SINGLE -FAMILY HOME SALES



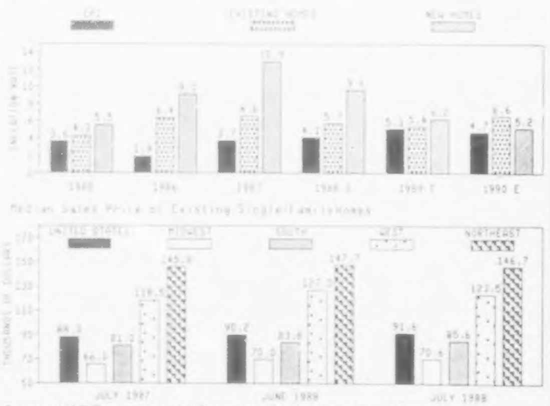
Source: NAR Economics and Research; E NAR Estimates

GRAPH 11:EXISTING SINGLE-FAMILY HOME SALES BY REGION



Source: NAR Economics and Research.

GRAPH 12: HOME PRICES



Source: NAR Economics and Research; E NAR Forecasting & policy.

DEPRECIATION OF REAL PROPERTY UNDER THE TAX CODE

Buildings deteriorate, cars corrode, computers become obsolete, and machinery wears out. While a business will undertake reasonable maintenance to prevent its assets from decaying, the fact remains that their useful lives are limited.

Depreciation is a normal process which occurs regardless of the amount of maintenance undertaken. Because it is a normal process, there is a need to recognize depreciation's effect on the value of properties used in business especially when determining the business's net income for tax purposes. The income tax rules should ideally allow for the expensing of a fixed percentage of the value of each long-lived asset each taxable year.

Experts feel that actual depreciation is approximated by a process of smooth, constant decay with different types of assets decaying at different rates. The tax rules, on the other hand, require that businesses use a fixed formula to determine the amount of depreciation expenses which can be deducted from earned income. These formulas depend upon the predicted lives of the assets and their historical costs to determine the dollar amount of these expenses each year.

Difficulties for investors in these capital goods arise when there are differences between the value of depreciation which has occurred and the value allowed to be deducted according to the formulas in the tax code. To determine the impact of these differences, this article compares the present value of these alternate measures of expenses. This analysis will determine how equitably real assets have been treated using the present values of actual and allowable depreciation expenses. Real assets will also be compared with other types of capital assets using the effective tax rate measure. Investors prefer those assets with the lowest effective tax rate.

I. INTRODUCTION

Experts in the economic theory of taxation assert that the goal of the tax structure should be to treat income from any source equally. However, difficulties arise when attempting to meet this criterion in practice when the measurement of cash flows depends upon accounting tools which may not accurately reflect the actual revenues received and the total costs incurred. These difficulties are most clearly evidenced in the case of capital goods, and particularly for structures.

Investment in real estate is now less attractive owing to the recent changes in the Internal Revenue Code. This study examines the effects of changes in the depreciation allowance for real assets as compared with their treatment under prior law. It will also examine the treatment with respect to the allowances for other types of depreciable assets such as computers, and construction equipment.

The results of this review indicate that the depreciation rates allowed under the current tax code do not allow for full recovery of actual costs within the life of the structure which in turn undermines the incentives for investment in capital goods.

Similarly, the current rules, although improved from the previous tax law, continue to discriminate against investors in structures as compared with investors in other goods. Any investment in machinery or equipment, but not real property, was previously eligible for an investment tax credit which reduced the effective tax rate on the income derived from this equipment.

These deficiencies, if left uncorrected, will generate underinvestment in capital goods in general and structures in particular. Economists believe that underinvestment in capital goods may lead to reduced productivity of labor and other factors of production which in turn could reduce the growth of the economy.

The Role of Accounting Methodologies in Measuring Cash Flows

Differences in the accurate measurement of revenues and costs arise from the use of cash and accrual methods of accounting. Cash accounting records income when actually received and recognizes costs when a debt is satisfied. Accrual accounting, on the other hand, recognizes income and expenses when they are incurred. As an example, large expenses are usually incurred in the early years of a construction project, while the income to be earned from those expenditures is spread somewhat evenly over many successive years. In order to treat this capital income equally with other types of income, it is necessary to allocate the project costs across the number of years over which income will be produced. These costs include the normal wear and tear from the use of the buildings and equipment.

Depreciation Defined

Economic Depreciation. Economists define economic depreciation as the decline in the value of an asset due to age. The accurate measurement of economic depreciation allows economists to gauge the growth of the economy as a whole and any sector within the economy.

Accounting Depreciation. Capital consumption allowances measure depreciation for tax purposes and depend upon formulas to allocate the historical cost of an asset over its depreciable lifetime. Accountants use exact formulas to calculate depreciation for two reasons: first, to determine net taxable income as required by the Internal Revenue Code (IRC), referred to as "tax depreciation"; second, to determine net earnings which will be reported to shareholders on financial statements and is referred to as "book depreciation." In order to determine taxable income, mathematical formulas are used by accountants to calculate the amount of the original purchase price of an asset which has been used during the year.

Several techniques for calculating depreciation expenses have been accepted under the tax code in the last several decades. These methods include straight-line, sum-of-the-years' digits, and declining-balance approaches. These methods and others approximate the amount of the asset which has been depleted during the year. The straight-line approach assumes that the same dollar amount of depreciation occurs in each year of the asset's life. Thus an asset purchased for $100,000 with an estimated life of ten years will be allowed a depreciation expense of $10,000 in each of the ten years. The sum-of-the-years' digits and the declining-balance methods assume that a larger share of the total depreciation occurs in the earlier years of the asset's life. In the example of the $100,000 asset, the sum-of-the-years' digits method allows an $18,182 expense in the first year of the asset's life, but only $1,818 in the tenth year. The double declining-balance method also allows more depreciation in the earlier years than does the straight line method. For comparative purposes, depreciation allowances for a hypothetical investment under each of these methods are demonstrated in Table 1.

Table 1
COMPARISON OF ALTERNATIVE
DEPRECIATION METHODS

Assumptions:

Investment amount	$100,000
Salvage value	$0
Asset lifetime	10 years

Depreciation Expense per Year

Year	Straight Line	Sum-of-the-Years' Digits	Double Declining-Balance
1	$10,000	$18,182	$20,000
2	10,000	16,364	16,000
3	10,000	14,545	12,800
4	10,000	12,727	10,240
5	10,000	10,909	8,192
6	10,000	9,091	6,554
7	10,000	7,273	5,243
8	10,000	5,455	4,194
9	10,000	3,636	3,355
10	10,000	1,818	2,684
Total	$100,000	$100,000	$89,263

Impact of Calculated Versus Actual Depreciation

Investment will be affected whenever the method of calculation allowed by law deviates from the actual decline in the asset's value. If the depreciation method required in the tax law is too strict, business owners will not be able to account for the full expense of operating their businesses during the taxable year. Specifically, a business could show a taxable profit while possibly incurring a loss because of the need to replace the capital before it reaches its full tax life. On the other hand, if the tax code is too lenient, capital owners will overinvest in buildings and other capital goods exclusively for the benefits of shielding other income from taxes. This process creates a surplus of these goods and depresses their value.

The Hulten and Wykoff Statistical Analysis of Economic Depreciation

A comprehensive study to determine economic rates of depreciation for various types of capital was performed by Charles R. Hulten and Frank C. Wykoff in 1981. The Hulten and Wykoff {HW} study provides a significant start to determine how equitably alternative investments are treated under the tax code. The HW study collected data on the average sales price of capital assets (new and used) by National Income and Product Accounts classification for each year and vintage. Their statistical analysis of the rate of decay yielded an estimate of the percent change in the price of each asset class for a one year change in age. This provides estimates of the economic rate of depreciation

Estimates of Economic Depreciation Rates

The Hulten-Wykoff study provides estimates of the rates of economic depreciation for six classes of non-residential structures. Their estimates for the industrial and commercial structure classes are presented in Table 2 below. Using these figures, an estimate of the present value of depreciation expenses can be found from a mathematical equation. These estimates are also presented in Table 2.

Table 2
ESTIMATES OF DEPRECIATION RATES
AND PRESENT VALUE OF ECONOMIC
DEPRECIATION

Structural Class	Depreciation Estimate	Present Value
Industrial	0.0361	$0.474
Commercial	0.0247	$0.382
Residential	0.0130	$0.245

Source: Hulten and Wykoff, and Jorgenson and Sullivan.

All calculations are based upon a one dollar investment. Larger investments are multiples of the estimates provided in the table.

In another study, Dale W. Jorgenson and Martin A. Sullivan, using the methodology developed in the HW study, estimated the rate of depreciation for residential structures. Their results for the residential class are also shown in Table 2.

Table 2 indicates that industrial structures depreciate at the fastest rate of these three classes. They lose about 3.6 percent of their value each year. The wear and tear reduces the output capacity of these structures each year and represents an additional cost of operation. If this cost from every year were to be paid up front in the first year of the asset's life, it would cost 47 cents per dollar of the asset's original value. The two other classes of structures depreciate more slowly and thus have lower present values of economic depreciation of about 38 cents per dollar for commercial structures and 25 cents per dollar for residential structures.

Measurement of Accounting Depreciation

The present value of economic depreciation has been calculated under the assumption of a smoothly and evenly declining asset value. However, to compare this economic depreciation with allowable depreciation, it is necessary to calculate the present value of allowable depreciation deductions. This computed value will depend upon the formulas for calculating deductions under the tax code.

The Tax Reform Act of 1986 (TRA) requires structures to use straight-line depreciation with lifetimes of 27.5 years for residential structures and 31.5 years for nonresidential structures. It is assumed that the structures are placed into service in the middle of the month of July of the first year in accordance with the mid-month convention of TRA. Thus the first year's depreciation is prorated by 11/24's. This convention removes any incentive for firms to make investments at the end of the tax year (or month) in order to receive a full year's (month's) depreciation. The current value of these depreciation expenses can then be determined by computing the present value of these flows. The estimates are given in Table 3.

Table 3
ESTIMATES OF THE PRESENT VALUE OF ALLOWABLE DEPRECIATION

Structural Class	Present Value*
Nonresidential	$0.347
Residential	$0.384

*All calculations are based upon a one dollar investment. Larger investments are multiples of the estimates provided in the table.

Comparing Depreciation Rates and the Present Value of Depreciation Allowed Under the Internal Revenue Code

The two current value measures of depreciation can be compared to determine whether the asset is fairly treated under the IRC (Table 3). A comparison of the treatment of similar assets under alternative tax proposals can be made by modifying the tax code.

Comparing the estimates of depreciation rates provided in the HW study with the present value of depreciation allowances permitted under the tax code, it appears that for industrial and commercial structures, the tax code is somewhat harsh under regular taxes. Residential properties fare better under the tax code than do nonresidential structures. Residential properties receive a current value equivalent deduction of 38 cents per dollar invested while incurring only an estimated 25 cents actual depreciation on the same dollar.

II. MEASURING THE AFTER-TAX RETURNS TO EACH INVESTMENT

The preceding section compared the treatment of a specific class of assets under alternative tax provisions. However, investors frequently wish to compare alternative investments to determine which will fare the best under the current tax code. To make this comparison, a methodology for examining the after-tax returns to each investment was developed by Robert E. Hall.

The Effective Tax Rates

The tax treatment of different classes of capital goods can be compared using an effective tax rate calculated for each class. The effective tax rate is the marginal tax rate on capital income which abstracts from any depreciation deductions and investment tax credits which may apply to various assets. This rate may differ from the statutory tax rate.

For example, a sole proprietor may own a computer used for word processing. The computer may produce $1,000 in income during the first year. Assuming a statutory tax rate of 34 percent, the tax on this income would be $340. However, the sole proprietor may take a depreciation deduction expense of $200 thereby reducing taxable income to $800. The tax burden would now be $272. If the computer were also eligible for a $100 tax credit, the tax liability would be reduced by this $100 to $172. The effective tax rate is 17.2 percent ($172 /$1,000 * 100%), just over half of the 34 percent statutory rate.

The effective tax rate (ETR) can be calculated for different classes of assets and compared. Hall estimated the effective tax rates for broad asset classes using the parameters provided in the tax code and assumed certain market rates of return to perform the analysis. Those classes with the lowest ETR are treated the most favorably and are preferred by investors. Calculations of effective tax rates for different asset classes for the 1981 ERTA rules from Hall's work are shown in Table 4.

Table 4
EFFECTIVE TAX RATES ERTA 1981 RULES

Asset	Rent	Effective Tax Rate	Depreciation Assumptions: Actual	Allowed	ITC
Equipment	0.139	-2.00	0.10	0.15	0.10
Plant	0.094	37.00	0.03	0.06	0.00
Intangibles	0.140	0.00	0.10	#	0.00

ITC -Investment Tax Credit

# -infinite depreciation (expensing), all depreciation expenses are deducted against income in the period the expenses are paid.

*Assumes a zero inflation rate and a 46 percent marginal corporate tax rate.

Source: Robert E. Hall, "Tax Treatment of Depreciation, Capital Gains, and Interest in an Inflationary Economy."

Using Hall's methodology, the effective tax rate for these classes under current tax law can be calculated. These estimates are given in table 5.

Due to favorable depreciation rates and the investment tax credit, equipment, such as automobiles and computers, in effect received a subsidy under the ERTA rules. Whereas commercial real property (plant) paid an effective corporate tax rate of 37 percent on the income

Table 5
EFFECTIVE TAX RATES TRA 1986 RULES

Asset	Rent	Effective Tax Rate	Depreciation Assumptions: Actual	Allowed	ITC
Equipment	0.161	21.0	0.11	0.25	0
Plant	0.098	36.0	0.04	0.03	0
Intangibles	0.140	0.0	0.10	#	0

ITC -Investment Tax Credit

# -infinite depreciation (expensing), all depreciation expenses are deducted against income in the period the expenses are paid.

*Assumes a zero inflation rate and a ~~34~~ percent marginal corporate tax rate

Source: NATIONAL ASSOCIATION OF REALTORS estimate.

earned. Income from intangible assets was effectively not taxed due to the complete write-off of the value of these types of assets in the year of their purchase.

Under the Tax Reform Act of 1986 rules, equipment now pays an effective 21 percent income tax rate, while real assets still pay a higher 36 percent rate. This illustrates that although the gap has narrowed, equipment continue to be favored over real property. In effect, intangibles are again not taxed.

III. CONCLUSIONS

Depreciation can and has been used as a tool in fiscal policy to help stimulate specific industries and the economy as a whole. If depreciation rates allowed under the tax code are higher than the rate at which deterioration actually occurs, then investors will have an incentive to purchase these favored assets. This situation can result from a policy decision to favor a particular class of assets or through a mismatch of the method of allowable depreciation with the actual depreciation.

Most analysts agree that actual, economic depreciation follows an exponential pattern. This pattern is most closely approximated by the declining balance method of accounting for depreciation expenses. The straight line method provides a very rough estimate of actual depreciation and can lead to less than full accounting for these expenses especially for long-lived assets.

Different classes of assets will generally have different effective tax rates, because specific industries can be targeted for more favorable treatment by adjusting the allowable depreciation rates. This effect can be magnified by the simultaneous use of an investment tax credit. An investment tax credit allows a certain percentage (or amount) of the purchase price of a capital good to be deducted directly from the purchaser's tax liability. The basis of the asset may be adjusted for the tax credit and thus the depreciation allowances will be based upon the purchase price of the asset less the investment tax credit.

The Role of ERTA

The ERTA of 1981 did not require the above adjustment to the basis, making assets eligible for the investment tax credit even more attractive than ineligible assets. Some analysts have suggested that the combination of short depreciable lives and liberal investment tax credits under the ERTA have resulted in negative effective tax rates for certain classes of assets, most notably automobiles and light-duty trucks. The classes of assets with longer depreciable lives and that were ineligible for the investment tax credit were subject to high effective tax rates and subsequently were not preferred by investors.

Real estate investments were not eligible for the investment tax credit under ERTA. While real property did receive faster depreciation under ERTA, these classes of assets did not receive the same treatment as did short-lived classes. Under current law, real estate investments still are less favored vis-a-vis other investments. This tax treatment bias against real estate has the potential to lead to pronounced problems from underinvestment in real capital and overinvestment in personal capital goods.

The Role of TRA

The Tax Reform Act of 1986 lengthened the depreciable lives for most capital assets and altered the method under which depreciation deductions must be calculated. Real properties must use the straight line method even though most experts agree that decay occurs in an exponential manner. Personal property may use the declining balance method but the recapture provisions will apply if the asset is sold before retirement.

The TRA partially levelled the differences in the effective tax rate of equipment versus real property, although short-lived assets are still favored over long-lived assets.

Source: Depreciation, Inflation, and the Taxation of Income From Capital, Ed. Charles R. Hulten, Washington, D.C., The Urban Institute Press, 1981.

1. Robert E. Hall, *Tax Treatment of Depreciation, Capital Gains, and Interest in an Inflationary Economy*, pp. 149-166.

2. Charles R. Hulten and Frank C. Wykoff, *The Measurement of Economic Depreciation*, pp. 81-123.

3. Dale W. Jorgenson and Martin A. Sullivan *Inflation and Corporate Capital*, pp. 171 237.

*This article is drawn from *The Tax Treatment of Real Estate Depreciation*, available from the National Association of Realtors.

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U.S. ECONOMIC OUTLOOK

September 1988

	QUARTERS								YEARS				
	ACTUAL		FORECAST						ACTUAL		FORECAST		
	88.1	88.2	88.3	88.4	89.1	89.2	89.3	89.4	1986	1987	1988	1989	1990
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4725	4820	4913	4989	5092	5171	5244	5316	4240	4527	4862	5206	5537
% Change	5.4	8.3	8.0	6.3	8.5	6.3	5.8	5.6	5.6	6.8	7.4	7.1	6.4
% Change (w/out inflation)	3.4	3.3	3.0	2.4	3.8	2.3	2.2	2.2	2.8	3.4	4.1	2.9	2.3
Index of Industrial Production	134.5	136.0	133.0	139.6	139.9	140.5	141.1	141.9	125.1	129.8	137.0	140.8	143.6
Manufacturing Capacity Utilization Rate	82.7	83.1	83.9	84.1	83.8	83.9	84.1	84.1	79.7	81.0	83.5	84.0	84.0
Domestic Auto Sales (millions)	7.6	7.5	7.9	7.6	7.4	7.4	7.3	7.3	8.2	7.1	7.7	7.3	7.2
Unemployment Rate - Civilian	5.7	5.4	5.3	5.2	5.1	5.1	5.0	5.0	7.0	6.2	5.4	5.1	5.0
Civilian Employment-Household basis (millions)	114.2	114.6	115.4	116.0	116.5	116.9	117.4	117.8	109.6	112.4	115.1	117.1	118.8
Percent change	2.6	1.5	2.7	2.2	1.4	1.6	1.5	1.5	2.3	2.6	2.3	1.8	1.4
Consumer Prices (CPI)	3.4	4.8	4.7	5.2	5.7	5.2	4.8	4.3	1.9	3.7	4.1	5.1	4.7
GNP Deflator	1.7	5.1	4.8	3.8	4.6	3.9	3.6	3.4	2.7	3.3	3.2	4.1	4.0
Federal Tax Receipts (NIPA) % of GNP	20.1	20.4	20.0	20.0	20.1	20.2	20.2	20.2	19.5	20.2	20.1	20.2	20.7
Federal Expenditures (NIPA) % of GNP	23.4	23.1	22.8	22.8	23.0	22.9	23.0	22.8	24.4	23.7	23.0	22.9	22.6
Deficit(NIPA)	-155.1	-130.9	-137	-138.7	-144.3	-141.5	-144.5	-141.2	-205.6	-157.8	-140.4	-142.9	-114.5
% of GNP	-3.3	-2.7	-2.8	-2.8	-2.8	-2.7	-2.8	-2.7	-4.9	-3.5	-2.9	-2.7	-2.1
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4314	4660	4579	4382	4205	4350	4389	4132	4712	4648	4484	4269	4214
Percent change -- year ago	-10.1	-0.8	1.1	-1.5	-2.5	-6.7	-4.2	-5.7	10.8	-1.4	-3.5	-4.8	-1.3
Existing Single-family Home Sales (thousands)	3250	3630	3550	3375	3210	3340	3410	3150	3565	3526	3451	3278	3205
Percent change -- year ago	-10.1	0.6	3.5	-0.4	-1.2	-8.0	-3.9	-6.7	10.9	-1.1	-2.1	-5.0	-2.2
Housing Starts (thousands)	1477	1477	1461	1419	1340	1381	1379	1388	1812	1634	1458	1372	1405
Percent change -- year ago	-17.0	-8.0	-9.7	-7.4	-9.3	-6.5	-5.6	-2.2	4.1	-9.8	-10.7	-5.9	2.4
Single-family Units	1097	1062	1063	1026	974	1012	1010	1014	1183	1157	1062	1002	1018
Percent change -- year ago	-11.9	-6.6	-7.9	-5.9	-11.2	-4.7	-5.0	-1.2	10.4	-2.2	-8.2	-5.6	1.5
Multi-family Units	380	415	398	393	366	370	369	374	630	477	397	370	387
2-4 Family Units	56.3	56.7	54.4	53.6	50.0	50.4	50.4	51.1	84.9	65.7	55.2	50.5	52.9
Percent change -- year ago	-29.0	-21.3	-1.7	-4.8	-11.2	-11.0	-7.3	-4.8	-9	-22.6	-16.0	-8.6	4.7
5 + Family Units	324	358	344	339	316	319	319	323	545	412	341	319	335
Percent change -- year ago	-28.7	-9.6	-16.0	-12.3	-2.3	-11.0	-7.3	-4.8	-5.6	-24.4	-17.1	-6.4	4.7
New Single-family Home Sales (thousands)	630	697	657	610	590	630	615	570	750	671	649	601	550
Percent change -- year ago	-12.9	3.4	-2.7	-1.8	-6.3	-9.6	-6.4	-6.6	9.0	-10.5	-3.4	-7.3	-8.5
Mobile Homes Shipped (thousands)	207	220	214	218	213	217	217	219	246	233	215	217	223
HOME PRICES													
Existing Home Prices - Median ($1000)	87.8	88.9	92.0	93.4	94.1	94.8	96.1	96.6	80.3	85.6	90.5	95.4	101.7
Percent change -- year ago	4.2	4.5	6.7	9.8	7.2	6.6	4.5	3.4	6.4	6.6	5.7	5.4	6.6
New Home Prices - Median ($1000)	112.9	112.9	114.5	115.5	117.0	121.0	122.5	123.7	92.0	104.0	114.0	121.1	127.5
Percent change -- year ago	16.0	9.1	7.8	3.3	3.6	7.1	7.0	7.1	9.1	12.9	9.6	6.2	5.2
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year FRM (FHA Secondary)	10.1	10.7	10.8	11.1	11.3	11.4	11.4	11.1	9.9	10.2	10.7	11.3	10.8
1-year ARM (without buydown)	7.5	7.6	7.6	7.9	8.2	8.3	8.2	8.0	7.9	8.2	7.7	8.2	7.6
30-year Corporate AAA Bond Rate	9.6	9.8	10.2	10.6	10.7	10.8	10.8	10.5	9.0	9.4	10.1	10.7	10.2
30-year Government Bond Rate	8.6	9.1	9.5	9.8	9.9	10.1	10.1	9.6	7.8	8.6	9.3	9.9	9.4
Short-Term Interest Rates													
Federal Funds Rate	6.7	7.2	8.0	8.2	8.4	8.5	8.5	8.1	6.8	6.7	7.5	8.4	8.0
3-month T-Bill Rate	5.7	6.2	7.1	7.4	7.6	7.8	7.9	7.5	6.0	5.8	6.6	7.7	7.1
Prime Rate	8.6	8.8	9.8	10.2	10.3	10.0	9.9	9.9	8.3	8.2	9.4	10.0	9.8
Discount Rate	6.0	6.0	6.3	6.7	6.9	6.9	6.9	6.9	6.3	5.7	6.3	6.9	6.7
Value of the U.S. Dollar (Trade-Weighted Avg.)	90.0	90.4	97.8	98.1	95.0	91.3	87.3	85.0	112.3	96.9	94.1	89.7	83.4
Percent Change	-9.4	1.7	37.1	1.1	-12.0	-14.7	-16.4	-10.1	-21.6	-13.6	-2.9	-4.7	-7.1

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr Frederick Flick, Sean Burns and Beth Maerz.

EQUAL HOUSING
OPPORTUNITY

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REAL ESTATE OUTLOOK

Vol. 1, No. 10

October 1988

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The effects of this summer's drought are finally having a measurable impact on the economy: the Commerce Department reported that a $12.2 billion decline in farm output pulled the real GNP estimate for the second quarter down by 1.2 percentage points.
- Government data shows that the unemployment rate dropped from 5.6 to 5.4 percent in September. While the September pace was strong, it lagged behind the average monthly increase of 345,000 jobs during the first half of 1988.
- In the midst of this continuing process of adjustment of the U.S. trade balance, the dollar will likely resume its downward trend of the last three years. This is likely as improvement in the trade deficit slows in coming months due to modestly slower manufacturing and export growth.
- While recent economic news has confirmed the U.S. economy is still growing, the effects of the Fed's monetary restraint earlier this year are increasingly being felt. Therefore, prospects are good for an environment of continued economic growth characterized by slow, steady improvement in the trade deficit, and a slowing in the rate of increase in interest rates.
- The most recent data shows that nearly two-thirds of homebuyers closing on home purchases during August chose an ARM. The availability of ARMs has helped buyers purchase larger, higher quality (and more expensive) homes than they could have qualified for with a fixed rate.
- After falling 5 percent in July, sales of existing single-family homes held their ground in August, increasing to a seasonally adjusted annual rate of 3.67 million units. The August pace was 1 percent above the July annual rate of 3.63 million units, and 7.6 percent faster than August of 1987.

IN THIS ISSUE

- **Economic Commentary: Happy Birthday, Dear Cra-ash, Happy Birthday to You!, by John A. Tuccillo**
- **Outlook for the Economy and Real Estate, by Sean A. Burns and Beth Maerz**
- **Social and Economic Benefits of Homeownership: NAR Survey Data Revisted, by Daniel N. Chambers and Mary B. Schwartz**

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HAPPY BIRTHDAY, DEAR CRA-ASH, HAPPY BIRTHDAY TO YOU!

ECONOMIC COMMENTARY

by
John A. Tuccillo
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Of course, this being the month of the first anniversary of Black Monday, I feel compelled to reflect on what has happened since. Edward Albee in *Zoo Story* has one of his characters note (after having reached Central Park by travelling south through Greenwich Village): "Sometimes ya gotta go a long way out of your way to get a little bit towards where you're goin'." In essence, in the past year, because of the crash and the ensuing financial market nervousness, we've done exactly as the Albee character suggests.

By now, we know that the crash did not bring down the economy, as advertised. Its systemic effects were localized in the Northeast and the combination of a strong economy and prompt Fed action kept the economy in general growing strongly. But we also know that the crash shattered the confidence of financial markets and created a world where rumors and shadows of rumors turned traders into dervishes. In a sense, the market seemed to be following Congress in that all it can do well is nothing or overreact. While the stock market didn't plunge as drastically as it did on October 19, there were many more 50-100 point days, and more frequent bond slumps and rallies.

Curiously, this nervousness, as dangerous as it seems, has produced a real stability in interest rates. Twice during the past year, the threat of increasing inflation has led to consensus forecasts of sharply higher rates. In the second instance, the Fed ratified these predictions by increasing the discount rate by a half point. Yet, although rates have drifted up and now stand higher than they were a year ago, we have not returned to the bad old days of 18 percent mortgages (or even 12 percent mortgages). Why not? Well, just like a cat doesn't wait to see the source of a sharp noise before it jumps, financial markets, driven by nervous profit-takers, move at the first hint of rate swings. The net result of this behavior is that catastrophes (no pun intended!) are averted and interest rate movements made more gentle.

All this suggests that the crash has changed financial markets. In reality, the crash was the last piece in a jigsaw puzzle that was constructed over most of the eighties. The application of advanced communications techniques to financial transactions set the borders of the puzzle, the opening of the U.S. economy to the rest of the world (ironically through a ballooned trade deficit) filled in the major features, and the change in trading behavior occasioned by the crash completed the scene. With anxious transactors hovering over computer screens around the world and receiving massive volumes of information, arbitrage in virtually all bond markets is a thing of the past (as is Ivan Boesky), significant news is acted on instantaneously and interest rate movements are dampened.

But let's take this a step further. The same jigsaw puzzle is shaping up on the real side of the economy, as well. Over the course of this decade, we have developed a variety of enterprises and even whole industries that are completely divorced from location. In a century, the economy's focus has moved from smelters in northern Minnesota to the steel mills of western Pennsylvania to the computer screen of anywhere, U.S.A. It's now a reality that mortgage processing can be done from northern Louisiana because the telephone makes it the equivalent of New York. And it makes sense to be there rather than New York because mortgage processors can be hired for a lot less.

This suggests a new view of the economy. For those businesses (and they are a growing presence in U.S. economic life) that need only a modem and an airport to operate, why not locate where labor and living costs are lowest? The last piece in the economic puzzle, then, is the behavioral change that will cause firms to relocate in areas of the country where the economy is in recession. In other words, the changes and lessons that have caused financial markets to operate in such a way that interest rate movements are dampened will be learned in the general economy. The result: a regional equalization of economic activity and an end to the "rolling recession" of the eighties.

Will this happen? Does it imply the end of the business cycle? Yes, and no. (Those are sequential answers, not the usual economist cop-out; my favorite color is *not* plaid.) The momentum of the marketplace, especially in a growing, technologically proficient, economy will finally convince the firms that can to take advantages of low cost, communications-sufficient areas. Local governments and civic groups will also recognize their advantages and convince firms that they possess that special niche. But the economy as a whole will move through booms and slumps, although like interest rates, these movements are likely to be of lesser magnitude.

All this sounds like a bold new economic outlook. In reality, it is very old. The technological and behavioral changes that have transformed, and are transforming, the marketplace are moving us closer to the world that Adam Smith dreamed more than two centuries ago. We may not be perfectly competitive, but the invisible hand is clearly at work. And this one may be digital but it has only electronic fingers. So let's wish a happy birthday to the crash. I'm almost glad it happened.

Outlook for the Economy and Real Estate

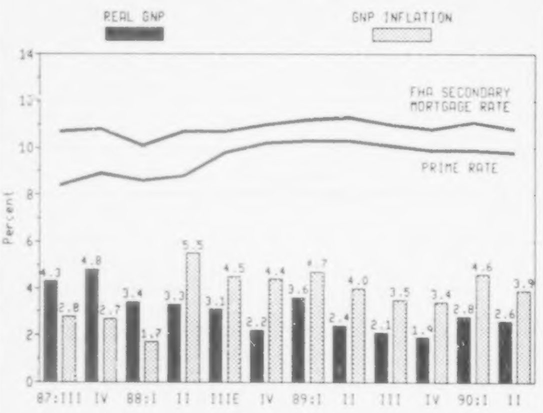
THE ECONOMIC OUTLOOK

The U.S. Commerce Department reported that the nation's total output of goods and services (GNP) advanced at an inflation-adjusted annual rate of 3.0 percent in the second quarter of this year. The effects of this summer's drought are finally having a measurable impact on the economy: the Commerce Department reported that a $12.2 billion decline in farm output pulled this real GNP estimate down by 1.2 percentage points. Roughly speaking, if the drought had not occurred, real GNP growth would have advanced at an annual rate of more than 4 percent in the second quarter. Still, this is a very strong rate of economic growth so late in the present economic expansion. The Commerce Department also announced that it plans to subtract 0.5 percentage points from its third quarter estimate to be released later this month, and it will shave 1.5 percentage points off its fourth quarter estimate as well. Therefore, the current forecast of an average annual rate of 2.6 percent real GNP growth for the second half of 1988 is actually an increase from the August *Real Estate Outlook*, because the September numbers include BEA's planned adjustments for the drought.

One of the most improtant indicators to watch has been the unemployment rate, which dropped from 5.6 to 5.4 percent in September. Non-farm payroll employment rose by 255,000 jobs to 106.7 million. Too fast a pace of job growth could mean the economy is overheating, a precursor to faster rates of inflation and higher interest rates. While the September pace was strong, it lagged behind the average monthly increase of 345,000 jobs during the first half of 1988. Further, all the job growth occurred within service-producing industries: the start of the school year increased public education employment by over 100,000 jobs. Employment in goods-producing industries fell by 9,000 jobs in September, the second consecutive monthly decline. Employment in goods-producing industries had increased for the past year and a half. The upshot of the employment report is the economy could grow at a modestly slower growth rate.

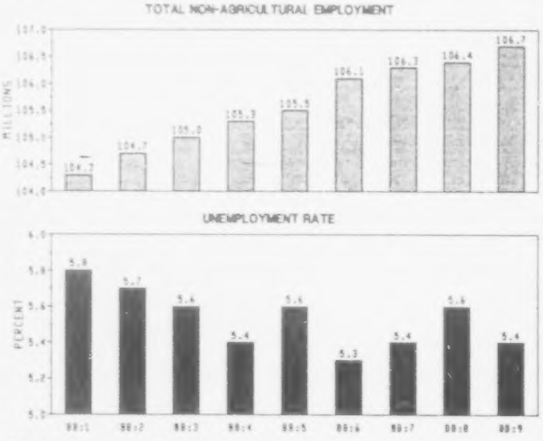
Another indicator of further economic growth is the recent gains in net exports (exports minus imports). The steady decline in the dollar since 1985 (until early 1988) has brought about declines in the merchandise trade deficit. While data on the trade deficit is lagged, it shows that the July U.S. trade deficit fell to $9.5 billion, an improvement of 28 percent over its June level. In the midst of this continuing process of adjustment of the U.S. trade balance, the dollar will likely resume its downward trend of the last three years. This is likely as improvement in the trade deficit slows in coming months due to modestly slower manufacturing and export growth. The combination of the pause in manufacturing employment job growth detailed in the employment report, and the sluggish growth of personal incomes (in an August report by BEA) creates an interesting outlook. First, the trade deficit will continue to improve, but not at a rate of 28 percent per month. Yes, slower manufacturing employment does imply less production of exports, but it also will cause slower growth in incomes of U.S. workers. Second, this slower income growth will curb import buying by U.S. consumers. The result could be less inflation here at home, and moderating interest rate increases.

GRAPH 1: THE ECONOMIC OUTLOOK



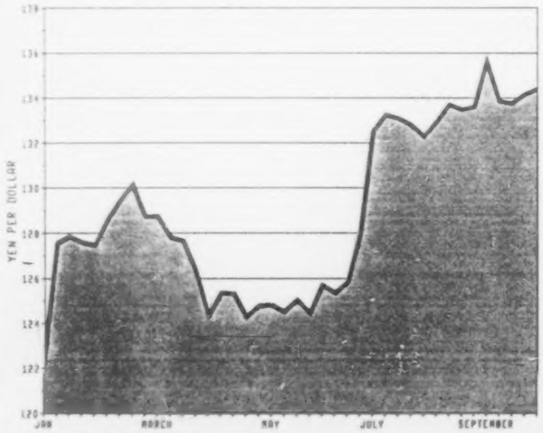
E NAR estimates(1988:III thru 1989:IV)

GRAPH 2: EMPLOYMENT CONTINUES TO RISE



SOURCE: Bureau of Labor Statistics.

GRAPH 3: THE DOLLAR WILL FALL AGAIN



SOURCE: Generale de Banque, New York.

The Federal Reserve's job has been made slightly easier by the most recent employment report. News that jobs are continually being created, but at a slower pace, could convince the monetary authority that U.S. economic growth is slowing modestly. This scenario, if played out, reduces the risk of faster rates of inflation and will possibly make the Fed less restrictive in its monetary policy. Over the course of 1988, the Fed has had to tighten the availability of credit, thereby raising interest rates, for fear that the U.S. economy is growing too quickly and could generate an accelerating rate of inflation. But while recent economic news has confirmed the U.S. economy is still growing, the effects of the Fed's monetary restraint are increasingly being felt. Therefore, prospects are good for an environment of continued economic growth characterized by slow, steady improvement in the trade deficit, and a slowing in the rate of increase in interest rates. The current forecast projects long-term interest rates to peak by the second quarter of 1989, with mortgage rates rising to just over 11 percent before declining through the remainder of the year.

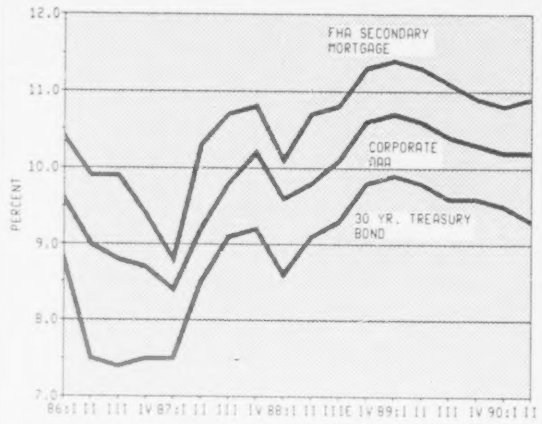
As the Fed attempts to manage economic growth through this period of strong concerns over an overheated economy and faster rates of inflation, many potential homebuyers are faced with making an important financial decision: whether to choose a fixed or adjustable rate mortgage (ARM). (This newsletter is not a replacement for the advice of real estate and financial professionals.) The most recent data shows that nearly two-thirds of homebuyers closing on home purchases during August chose an ARM. One of the most important factors in this decision is the spread between the fixed and adjustable rates. The data in the graph presents this spread for rates which are adjusted for the value of points (hence, effective rates). The availability of ARMs has helped buyers purchase larger, higher quality (and more expensive) homes than they could have qualified for with a fixed rate. For the housing sector, the popularity of ARM's has helped extend the current housing cycle, helping to explain the continued strength of existing home sales.

REAL ESTATE MARKETS

Housing Starts

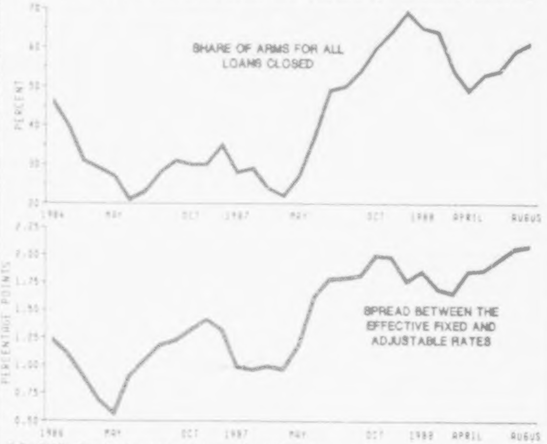
Total housing starts slowed in August to a seasonally adjusted annual rate of 1.436 million units, down 3.3 percent from July's rate of 1.485 million units and 9.3 percent below the August 1987 rate of 1.583 million units. The slowdown was due to a retreat in starts of multi-family structures with five or more units, which fell 21.9 precent in August to an annual rate of 289 thousand units. This drop followed July's 19 percent rise, demonstrating the high volatility in starts of these units. Starts of these units have been affected by the recent tax legislation, rising interest rates, and high apartment vacancy rates (11.8 percent in the second quarter). In contrast, single-family starts reached an annual rate of 1.086 million units in August, up 2.1 percent from July's rate of 1.064 million units. However, as higher interest rates continue to put downward pressure on housing demand, starts of single-family units are expected to slow, falling to a rate of 989 thousand units in 1989.

GRAPH 4: LONG-TERM INTEREST RATES



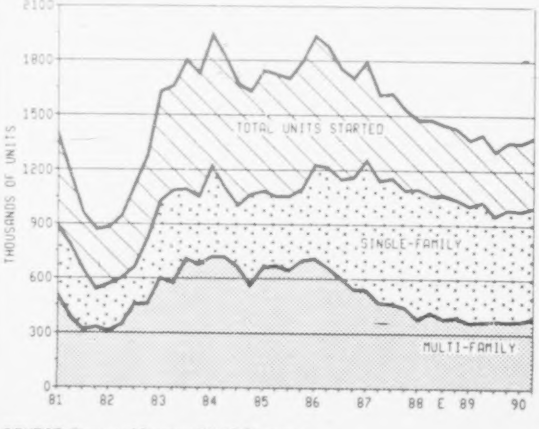
SOURCE: The Federal Reserve Board.

GRAPH 5: THE SHARE OF ARM'S IS GROWING



SOURCE: The Federal Home Loan Bank Board..

GRAPH 6: HOUSING STARTS

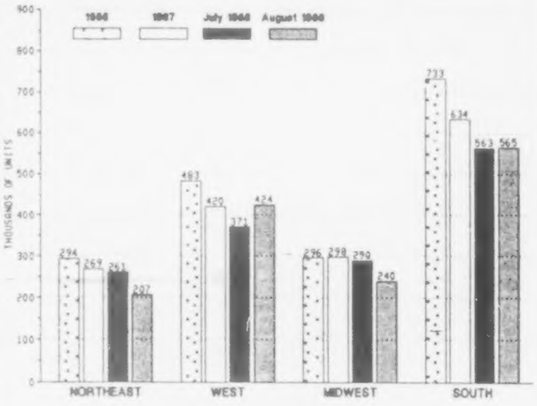


SOURCE: Bureau of Census; E NAR Estimates.

Housing Starts By Region

The only region to experience any significant gains in housing starts during August was the West, where starts rose 14.3 percent from July to a seasonally adjusted annual rate of 424 million units, the West's fastest pace since November of 1987. Starts in the West rose 0.7 percent over their August 1987 annual rate of 421 thousand units. In contrast, housing starts in both the Northeast and the Midwest fell sharply in August, tumbling 20.7 percent in the Northeast to a seasonally adjusted annual rate of 207 thousand units, and 17.2 percent in the Midwest to a rate of 240 thousand units. Compared with the pace set last August, starts were down 16.9 percent in the Northeast and 12.4 percent in the Midwest. In the South, starts were relatively flat in August, rising less than one percent to an annual rate of 565 thousand units. However, this marked an 11.5 percent drop from last August's annual rate of 639 thousand units and it may be one of the first signs of an overbuilt market in the Southeast, where high vacancy rates are expected to slow construction in the future.

GRAPH 7: HOUSING STARTS BY REGION

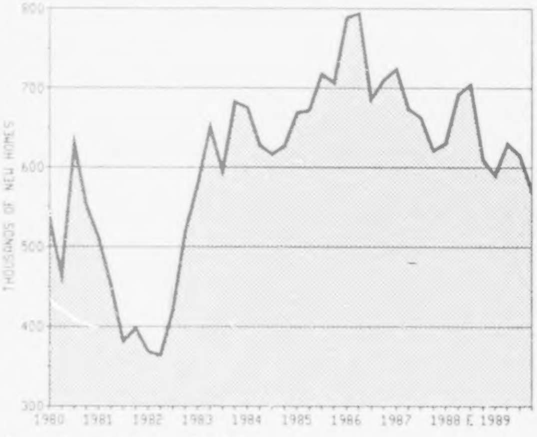


Source: Bureau of Census; E NAR Estimates

New Home Sales

New home sales during the month of August were unchanged from July, with the seasonally adjusted annual rate of new single-family home sales creeping up by a fractional 0.1 percent to 713 thousand units, from July's rate of 712 thousand units. The August rate, which was 6 percent faster than that of a year ago, marks the third month in a row that new home sales have exceeded 700 thousand units, a pace reached last in April, 1987. In the Midwest, where the rate of new home sales has fluctuated around 90 thousand units since March, sales jumped 10.8 percent to an annual rate of 103 thousand units. Sales in the West fell by a surprising 5.2 percent to a 217 thousand unit annual rate. During the six months preceeding this drop, new home sales in the West increased by 40 percent, to an annual rate of 229 thousand units in July, from February's rate of 164 thousand units. In the Northeast, sales reached an annual rate of 107 thousand units, 2 percent above July's rate, but 4.5 percent below the 112 thousand unit rate of last August. Sales were up only 0.3 percent in the South to a rate of 287 thousand units, 3.6 percent faster than the rate of sales a year ago.

GRAPH 8: NEW HOME SALES

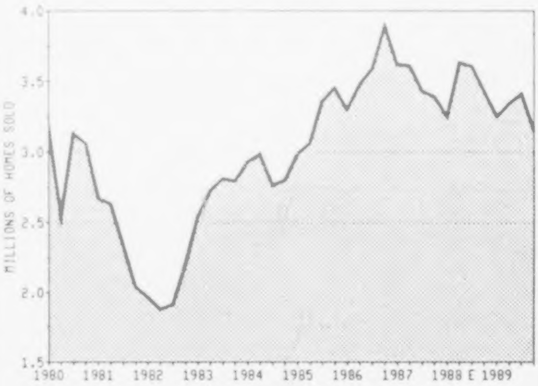


Source: Bureau of Census.; E NAR Estimates.

Existing Home Sales

After falling 5 percent in July, sales of existing single-family homes held their ground in August, increasing to a seasonally adjusted annual rate of 3.67 million units. The August pace was 1 percent above the July annual rate of 3.63 million units, and 7.6 percent faster than August 1987, when existing homes were sold at a seasonally adjusted annual rate of 3.41 million units. Sales of existing homes, which have been surprisingly strong this quarter despite the rise in interest rates, owe much of their recent strength to continued economic growth and extremely low rates of unemployment. However, as the steam from this economic expansion cools, existing single-family home sales are expected to moderate. In the fourth quarter of 1988, the annual rate of existing single-family home sales is expected to reach 3.43 million units, before declining to a 3.29 million unit pace in 1989.

GRAPH 9: EXISTING SINGLE-FAMILY HOME SALES



Source:: NAR, E NAR ESTIMATES

Existing Home Sales By Region

Regionally, existing single-family home sales reflected the little changed, strong annual rate experienced across the nation, with changes occuring only in the Northeast and the South. In the Northeast, sales fell 2.9 percent in August to a seasonally adjusted annual rate of 670 thousand units, down from July's rate of 690 thousand units and exactly even with the rate of sales in August, 1987. Sales in the South reclaimed all of the ground they lost in July, rising 4.4 percent in August to a seasonally adjusted annual rate of 1.42 million units. Existing home sales have been particularly strong in the South during the past few months, putting August's sales 10.1 percent above the rate of 1.29 million units set a year ago, and just 2.7 percent below the South's all time high of 1.46 million units in November of 1986. In the Midwest, sales held steady at a seasonally adjusted annual rate of 910 thousand units, which was 5.8 percent faster than the August 1987 annual rate of 860 thousand units. Sales in the West remained at an annual rate of 650 thousand units, 10.2 percent faster than last year's rate of 590 thousand units.

Home Prices

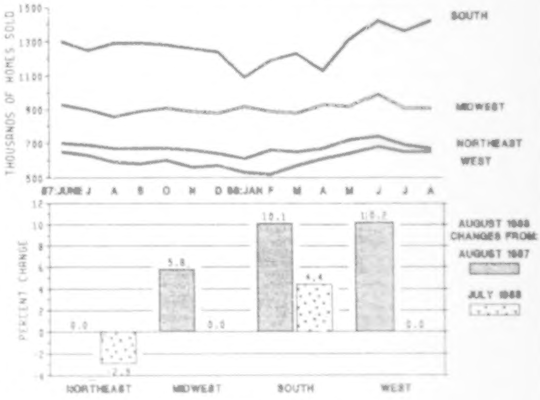
The median price of an existing single-family home changed only slightly in August, inching up $600 (0.66 percent) to $91,300 from the July median price of $90,700. However, the August price registered a gain of 5.5 percent over that of a year ago when the median price of an existing single-family home was $86,500. Meanwhile, the median price of a new home, which jumped by 6.7 percent in July, fell by 6.7 percent in August to $112,000, landing 4.9 percent above last August's price of $106,800.

Home Prices By Region

In the West, the median price of an existing single-family home fell in August for the second consecutive month to $122,000, down 2.6 percent from July when the median home was sold for $125,300 and 4 percent below June's price of $127,000. However, homes in the West appreciated by 6 percent, with respect to one year ago. The median sales price of a home in the Northeast rose by a modest $100 dollars in August to $144,800, putting it 6.7 percent above last August's sales price of $135,000. While the annual rate of home price appreciation in the Northeast is competitive with that of the rest of the nation, it undoubtedly seems slow to a region where home prices accelerated by 17.9 percent in 1986 and 28.5 percent in 1987. During that time, the national median price appreciated by 6.4 and 6.6 percent for 1986 and 1987, respectively. In the South, the price of an existing home was down 0.5 percent to $84,300, 4.3 percent higher than last August's price, and in the Midwest, prices increased by 1.4 percent to $70,500, 6.0 percent above the median price of one year ago.

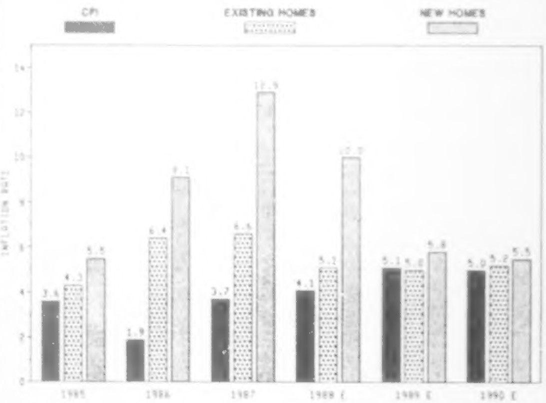
Sean Burns,
Director of Forecasting
Beth Maerz,
Research Associate
Forecasting & Policy Analysis Division

GRAPH 10: EXISTING SINGLE -FAMILY HOME SALES BY REGION



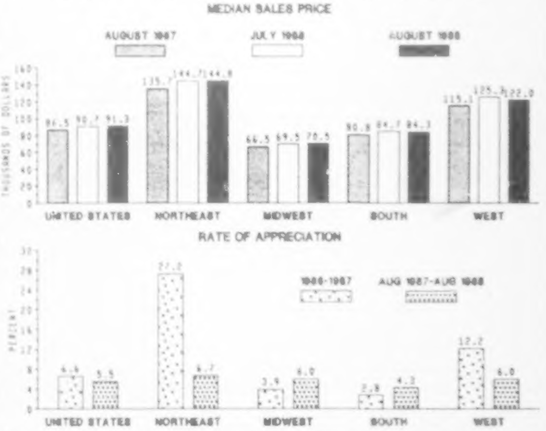
Source: NAR Economics and Research; E NAR Estimates

GRAPH 11: HOME PRICES



Source: NAR Economics and Research.

GRAPH 12: HOME PRICES BY REGION



Source: NAR Economics and Research; E NAR Forecasting & policy.

SOCIAL AND ECONOMIC BENEFITS OF HOMEOWNERSHIP:

NAR Survey Data Revisited

INTRODUCTION

People value and seek homeownership for many reasons. Ownership means the freedom to use or modify a dwelling as the owner-occupant sees fit. There is a pride and permanence in ownership which leads, in part, to better-maintained housing. Moreover, homeownership (usually, single-family dwellings) satisfies many personal needs, such as privacy. The article "Obstacles to Becoming a First-Time Homebuyer: A Look at NAR Survey Data," in the August, 1988 *Real Estate Outlook*, focused on these *individual* benefits of homeownership and the obstacles confronting those wishing to obtain it, using data from the 1986 NAR Homeownership Survey. See it for a brief discussion of the survey.

The present article utilizes the same survey data but focuses on the larger social benefits that follow from the individual pursuit of homeownership. Households with a greater stake in the community are more involved in local, and even national, issues. Homeowners' greater involvement in government reflects that policies affecting their neighborhoods and local public services ultimately impact the investment value of their homes. Their greater stake in society heightens their concern as citizens and neighbors.

Often attributed to homeownership, a better-maintained housing stock extends the life span of housing, which then makes it more readily usable in future decades. Homeownership also provides a vehicle for long-term savings and wealth accumulation. The "forced" savings through homeownership provides households with a pool of wealth, home equity, which makes them more self sufficient. Collectively, this individual household savings adds to the economy's savings and consequently to its ability to invest in the capital stock necessary to the nation's economic growth and well-being.

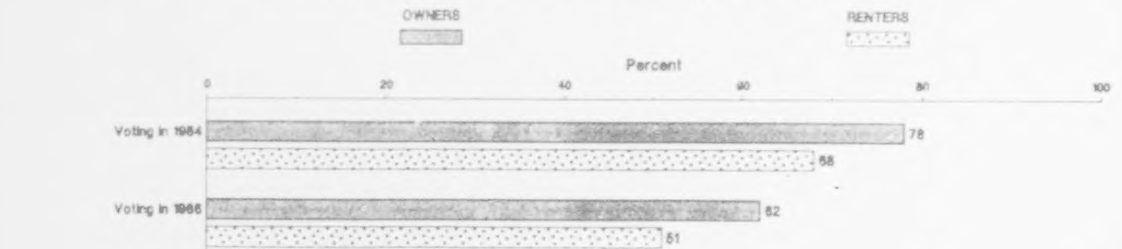
COMMUNITY, POLITICAL AND CHARITABLE ORGANIZATION INVOLVEMENT

The NAR survey results show that homeowners are more politically active, as supported by their greater rate of voter registration, participation in general elections, knowledge of national and local issues and candidates, money and time contributions to various political action committees, and attendance at public hearings of local governments. Moreover, a greater percentage of homeowners indicate contributions of both time and money to community programs and charitable and religious organizations.

The greater "citizenship" participation of homeowners holds even when controlling for other factors such as age and income. Among middle-income ($15,000 to $30,000 in 1984) households under age 40, 62 percent of homeowners voted in 1986 while 51 percent of renters did; a greater share of homeowners also voted in 1984. See Chart 1. Moreover, 42 and 51 percent of these young, middle-income homeowners indicated substantial knowledge of local political candidates and had substantial knowledge of the political issues affecting their communities, respectively, compared to 37 and 47 percent for renters.

Table 1 shows that homeowners tended to be more "volunteering" of their time. For middle-income

CHART 1: COMMUNITY AND POLITICAL INVOLVEMENT
(HOUSEHOLDS UNDER 40, 1984 INCOMES BETWEEN $15,000 AND $30,000)



SOURCE: 1986 NAR HOMEOWNERSHIP SURVEY

Table 1

Time Volunteered to Charitable Organizations

(Percent of Households Volunteering Within Last 2 Years)

	Under 40 Years Old		**40 - 60 Years Old**	
	Homeowners	*Renters*	*Homeowners*	*Renters*
Income				
Under $15,000	31%	27%	35%	37%
$15,000 - $30,000	41	35	46	38
Over $30,000	41	38	53	47

Source: 1986 NAR Homeownership Survey.

households under 40 years old, 41 percent of homeowners indicated that they had volunteered time to charitable/religious organizations within the past two years, while 35 percent of renters had. Even for older households (age 40-60), the spread was evident: 46 percent to 38 percent for homeowners and renters, respectively.

The evidence from NAR's survey supports the conclusions of other studies. In particular, one such study finds that homeownership *per se* makes a household more likely to espouse traditional values, more likely to be involved in volunteer activities and more likely to socialize informally with neighbors.[1] All told, then, homeownership enhances citizenship.

Table 2

Maintenance Effort and Housing Conditions by Tenure

(Percent of Households)

	Homeowners	Renters
Maintenance Efforts		
Maintenance in prior year:		
No	19%	47%
Yes	81	53
Maintenance expenses $100 +:		
No	50	78
Yes	50	22
Housing Conditions		
Interior problems:		
No	98	87
Yes	2	13
Exterior problems:		
No	97	81
Yes	3	19
Structural problems:		
No	98	84
Yes	2	16

Source: George C. Galster, "Empirical Evidence on Cross-Tenure Differences in Home Maintenance and Conditions," *Land Economics*, Vol. 59, (1983).

MAINTENANCE OF THE HOUSING STOCK

Another societal benefit of homeownership is better preservation of the housing stock. One recent study found that owner-occupants exhibited a significantly greater level of maintenance effort than occurred in rental housing. See Table 2. The table also shows that persistently greater maintenance has apparently led to housing in better condition, as evidenced by fewer structural and other problems in owner-occupied housing. Even comparing households of similar incomes, the superiority of owner-occupant maintenance efforts and housing conditions generally persists.

Similar evidence obtains from NAR's survey, which shows that owned homes are generally in better condition (maintained better over the years) than similar rented homes. The 1986 NAR Homeownership Survey provides information on the existence/seriousness of defects in respondents' homes. Not surprisingly, *both* owners and tenants of newer single-family detached housing express fewer problems with wiring, cracks and water leakage than owners and tenants of older housing; however, even within the "newer" homes, there were cross-tenure differences in maintenance. See Chart 2. Indeed, for each vintage of homes, homeowners generally have cited fewer problems than renters with both interior and exterior maintenance of their homes.

The differences between tenures in condition/maintenance are most pronounced for older housing. For housing built before 1940, in 1986 renters reported a much greater incidence of problems with exposed wiring, open holes/crack, and water leakages from roof/ceiling, ranging between 13 and 23 percentage points. But, even for newer homes (built between 1970 and 1979), homeowners indicated fewer and less serious maintenance problems and structural defects, on the same order of magnitude.

Besides the economy-wide advantage of a longer-lived housing stock overall, the greater maintenance associated with homeownership also has important benefits to neigh-

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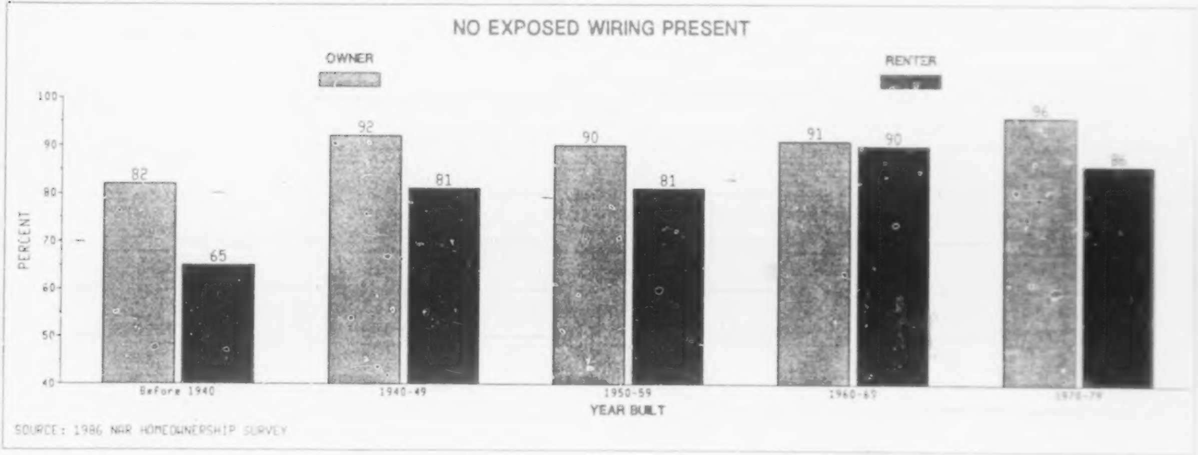
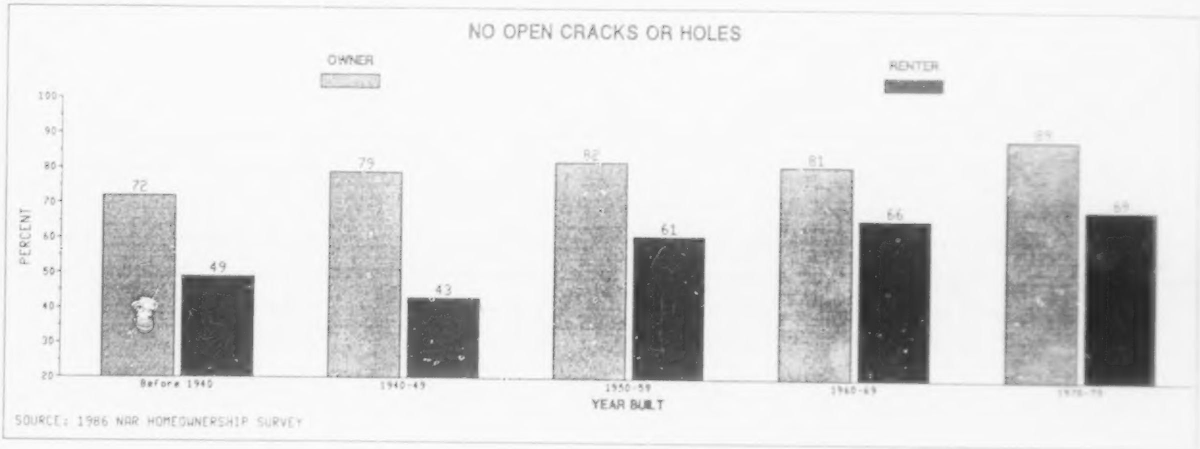
[1] Ronald Krumm, "Homeownership and Household Savings Behavior: A Study of Panel Data Patterns," report prepared for the National Association of Realtors, June 1985. (Mimeographed.)

Chart 2
Incidence of Maintenance and Quality Problems Reported in 1986 (Single-family Detached Only) Owners vs. Renters

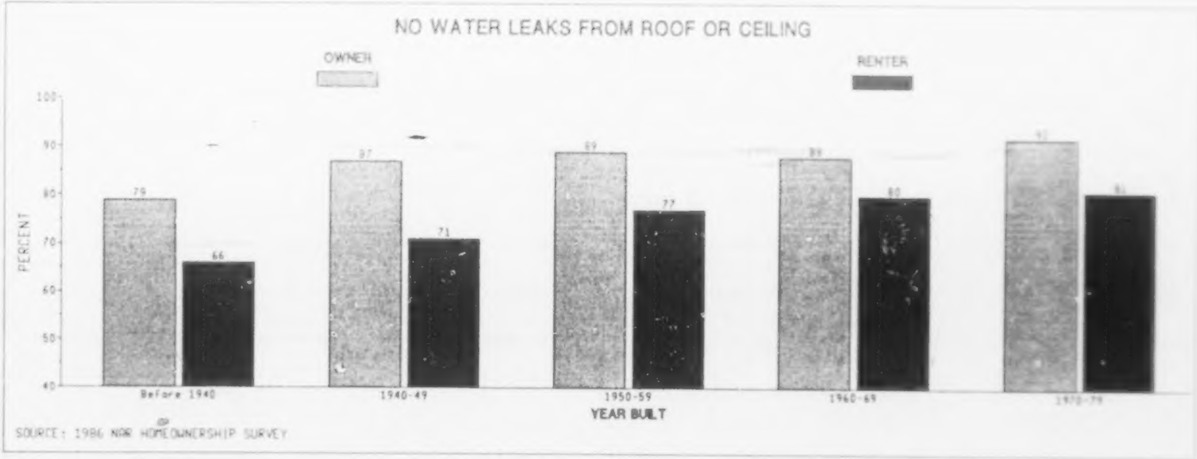
(Percent who responded "no problem at all")



SOURCE: 1986 NAR HOMEOWNERSHIP SURVEY



SOURCE: 1986 NAR HOMEOWNERSHIP SURVEY



SOURCE: 1986 NAR HOMEOWNERSHIP SURVEY

borhoods. When owner-occupants in a neighborhood all maintain their homes, it raises the quality of the neighborhood, as well as the value of all the houses in that neighborhood. That is, maintenance of houses -- encouraged by homeownership -- enhances the livability and desirability of entire neighborhoods.

INDIVIDUAL AND SOCIAL BENEFITS OF SAVING THROUGH A HOME

There are many benefits to saving through a home. For one thing, the individual homeowner benefits through the tax deferral of capital gains realized upon a home sale (if gains are rolled over into another house of equal or greater value within two years). This and other tax incentives encourage households to accumulate home equity, that is, to hold a substantial share of their wealth in this form. Because housing is such a valuable asset and represents such a relatively large store of wealth, households will maintain it better, as we document above. The increased maintenance of owner-occupied housing contributes to a higher-quality housing stock, not to mention the future savings from the decreased need for repairs and rehabilitation expenditures.

Furthermore, as a result of the one-time exclusion of capital gains from taxation, homeowners 55 years or older can generate untaxed savings and withdraw equity from their homes (e.g., selling their homes) for meeting expenditure needs and wants in retirement.

These incentives to save through home equity lead to home equity as households' predominant form of savings. According to the Federal Reserve's Survey of Consumer Finances, home equity accounts for over one half of the total wealth of a typical household.

The NAR survey data bear out that home equity occupies an important place in homeowners' savings/investment portfolios, particularly the portfolios of first-time homeowners. Of all the first-time homeowners in the NAR survey, over one-half (56%) indicated that they had saved/invested less than five percent of their incomes in each of the prior five years; and one-quarter of them saved less than one-percent. This lack of non-home equity savings is even more pronounced for young first-time homeowners. Of those under 40 years old, almost two-thirds of them saved/invested less than five percent of their household income during the preceding five years; and 35 percent saved less than one percent. See Table 3.

It has been suggested that government incentives to increase investment in housing, i.e., through preferential tax treatment, may reduce the level of investment in the non-housing sectors of the economy and lead to a possible misallocation of resources. However, one study suggests that a household's decision to buy its home (as opposed to renting) generally raises the *level* as well as changes the *composition* of its savings portfolio.[2] A greater homeownership rate may well raise the aggregate supply of funds available for all types of investment in the economy.

CONCLUSIONS

The benefits of homeownership transcend the individual homeowner. The evidence from the NAR survey substantiates that homeowners generally vote more often and are more involved in local political and charitable activities than otherwise comparable renters. Also, there is considerable evidence that homeowners maintain their housing in better condition than do comparable renters, which contributes to a long-lived and more useful national housing stock. Moreover, greater homeownership apparently leads to a higher level of national savings in addition to being vital to individual households' portfolios.

In short, there are numerous benefits of homeownership -- both to individuals and to the larger society.

by
Daniel N. Chambers
Director of Housing Research
and
Mary B. Schwartz
Housing Economist

Table 3: Non-Home Equity Savings:
(First-time Homeowners Under 40 Years)

Percentage of income saved /invested over the prior 5 years	Percentage of homeowners indicating saving/investing	Cumulative percent
Less than 1 percent	34.6%	34.6%
1 to 5 percent	31.4%	65.9%
6 to 10 percent	15.4%	81.4%
11 to 15 percent	6.2%	87.6%
16 to 20 percent	4.1%	91.6%
more than 20 percent	4.3%	95.9%
No response	4.1%	100.0%

Source: 1986 NAR Homeownership Survey.

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[2] Terry C. Blum and Paul William Kilyston, "Homeownership and Social Attachment," Sociological Perspectives, 27 (1984), pp.159-80.

U.S. ECONOMIC OUTLOOK

October 1988

	QUARTERS								YEARS				
	ACTUAL		FORECAST						ACTUAL		FORECAST		
	88.1	88.2	88.3	88.4	89.1	89.2	89.3	89.4	1986	1987	1988	1989	1990
AGGREGATE ECONOMY													
Gross National Product (billions of dollars)	4725	4824	4912	4992	5094	5174	5246	5314	4240	4527	4863	5207	5548
% Change	5.4	8.7	7.5	6.7	8.4	6.5	5.6	5.3	5.6	6.8	7.4	7.1	6.6
% Change (w/out inflation)	3.4	3.0	3.1	2.2	3.6	2.4	2.1	1.9	2.8	3.4	3.9	2.7	2.5
Consumer Price Inflation (CPI)	3.4	4.8	4.9	5.0	5.3	5.2	4.8	4.6	1.9	3.7	4.1	5.1	5.0
GNP Inflation (GNP Deflator)	1.7	5.5	4.5	4.4	4.7	4.0	3.5	3.4	2.7	3.3	3.3	4.3	4.0
Unemployment Rate - Civilian	5.7	5.4	5.5	5.5	5.5	5.6	5.6	5.6	7.0	6.2	5.5	5.6	5.6
Civilian Employment-Household Basis (millions)	114.2	114.6	115.2	115.8	116.1	116.4	116.8	117.2	109.6	112.4	115.0	116.6	118.1
Percent change	2.6	1.5	1.9	2.3	0.9	1.1	1.2	1.3	2.3	2.6	2.2	1.4	1.3
Index of Industrial Production	134.5	136.0	138.1	139.0	139.0	139.5	140.2	140.8	125.1	129.8	136.9	139.9	142.9
Manufacturing Capacity Utilization	82.7	83.2	83.8	83.8	83.3	83.4	83.6	83.5	79.7	81.0	83.4	83.4	83.7
Domestic Auto Sales	7.6	7.5	7.5	7.3	7.1	7.1	7.1	7.0	8.2	7.1	7.5	7.1	7.0
Federal Tax Receipts (NIPA) as % of GNP	20.1	20.4	20.0	20.1	20.1	20.2	20.2	20.2	19.5	20.2	20.1	20.2	20.7
Federal Expenditures (NIPA) as % of GNP	23.4	23.1	22.9	22.8	23.0	23.0	22.9	22.9	24.4	23.7	23.1	22.9	22.9
Deficit(NIPA)	-155.1	-133.3	-143.4	-139.0	-144.6	-143.6	-144.7	-145.8	-205.6	-157.8	-142.7	-144.7	-121.8
as % of GNP	-3.3	-2.8	-2.9	-2.8	-2.8	-2.8	-2.8	-2.7	-4.9	-3.5	-2.9	-2.8	-2.2
REAL ESTATE MARKETS													
HOME SALES													
Total Single-family Home Sales (thousands, single-family resales plus 97 percent of single-family starts)	4314	4660	4635	4435	4225	4336	4317	4106	4712	4648	4511	4246	4172
Percent change – year ago	-10.1	-0.8	2.3	-0.3	-2.0	-7.0	-6.9	-7.4	10.8	-1.4	-2.9	-5.9	-1.7
Existing Single-family Home Sales (thousands)	3250	3630	3605	3425	3250	3340	3410	3150	3565	3526	3478	3288	3205
Percent change – year ago	-10.1	0.6	5.1	1.0	0.0	-8.0	-5.4	-8.0	10.9	-1.1	-1.4	-5.5	-2.5
Housing Starts (thousands)	1477	1477	1445	1430	1368	1395	1308	1355	1812	1634	1457	1356	1382
Percent change – year ago	-17.0	-8.0	-10.7	-6.7	-7.4	-5.6	-9.5	-5.3	4.1	-9.8	-10.8	-6.9	1.9
Single-Family Units	1097	1062	1063	1041	1006	1027	936	986	1183	1157	1066	989	997
Percent change – year ago	-11.9	-6.6	-7.9	-4.5	-8.3	-3.3	-12.0	-5.3	10.4	-2.2	-7.9	-7.2	0.9
Multi-Family Units	380	415	382	389	362	368	372	369	630	477	392	368	384
2-4 Family Units	56	57	52	53	50	50	51	50	85	66	55	50	53
Percent change – year ago	-29.0	-21.3	-5.7	-5.7	-12.2	-11.4	-2.6	-5.3	-9.0	-22.6	-17.0	-8.0	4.5
5+ Family Units	324	358	330	336	313	318	322	318	545	412	337	318	332
Percent change – year ago	-28.7	-9.6	-19.3	-13.1	-3.3	-11.3	-2.6	-5.3	-5.6	-24.4	-18.1	-5.8	4.5
New Single-family Home Sales (thousands)	630	697	705	610	590	630	615	570	750	671	661	601	550
Percent change – year ago	-12.9	3.4	4.4	-1.8	-6.3	-9.6	-12.8	-6.6	9.0	-10.5	-1.6	-9.0	-8.5
Mobile Homes Shipped (thousands)	206.7	219.7	202.9	209.5	207.2	208.1	213.9	219.0	245.5	232.8	209.7	212.0	224.8
HOME PRICES													
Existing Home Prices - Median $(1000)	87.8	88.9	91.2	91.8	92.3	94.2	95.0	96.2	80.3	85.6	89.9	94.4	99.3
Percent change – year ago	4.2	4.5	6.7	8.0	5.1	6.0	4.2	4.8	6.4	6.6	5.1	5.0	5.2
New Home Prices - Median $(1000)	112.9	112.9	115.5	116.3	117.4	121.3	122.0	123.7	92.0	104.0	114.4	121.1	127.7
Percent change – year ago	16.0	9.1	8.8	4.1	4.0	7.4	5.6	6.4	9.1	12.9	10.0	5.8	5.5
FINANCIAL MARKETS													
Long-Term Interest Rates													
30-year FRM (FHA Secondary)	10.1	10.7	10.7	11.0	11.2	11.3	11.0	10.8	9.9	10.2	10.6	11.1	10.7
1-year ARM (without buydown)	7.5	7.6	7.6	7.8	8.1	8.2	8.2	8.3	7.9	8.2	7.6	8.2	7.8
Corporate AAA Bond Rate	9.6	9.8	10.2	10.5	10.6	10.8	10.5	10.3	9.0	9.4	10.0	10.6	10.2
Government Bond Rate	8.6	9.1	9.5	9.7	9.9	10.0	9.7	9.6	7.8	8.6	9.2	9.8	9.4
Short-Term Interest Rates													
Federal Funds Rate	6.7	7.1	8.1	8.3	8.5	8.7	8.6	8.3	6.8	6.7	7.6	8.5	8.0
3-month T-Bill Rate	5.7	6.2	7.2	7.4	7.6	7.7	7.6	7.4	6.0	5.8	6.6	7.6	7.1
Prime Rate	8.6	8.8	9.8	10.2	10.3	10.3	10.1	9.9	8.3	8.2	9.4	10.2	9.7
Discount Rate	6.0	6.0	6.4	6.7	6.9	6.9	6.9	6.9	6.3	5.7	6.0	6.5	6.7
Value of the U.S. Dollar (Trade-Weighted Avg.)	90.0	90.4	97.4	96.5	93.3	90.4	86.7	84.3	112.3	96.9	93.6	88.7	82.4
Percent change	-9.4	1.7	34.5	-3.7	-12.5	-11.9	-15.4	-10.5	-21.6	-13.6	-3.5	-5.2	-7.0

Source: Forecast produced using Laurence H. Meyer and Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Dr Frederick Flick, Sean Burns and Beth Maerz.

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